

add
DOCUMENT SCIENCES

Keep it Personal™

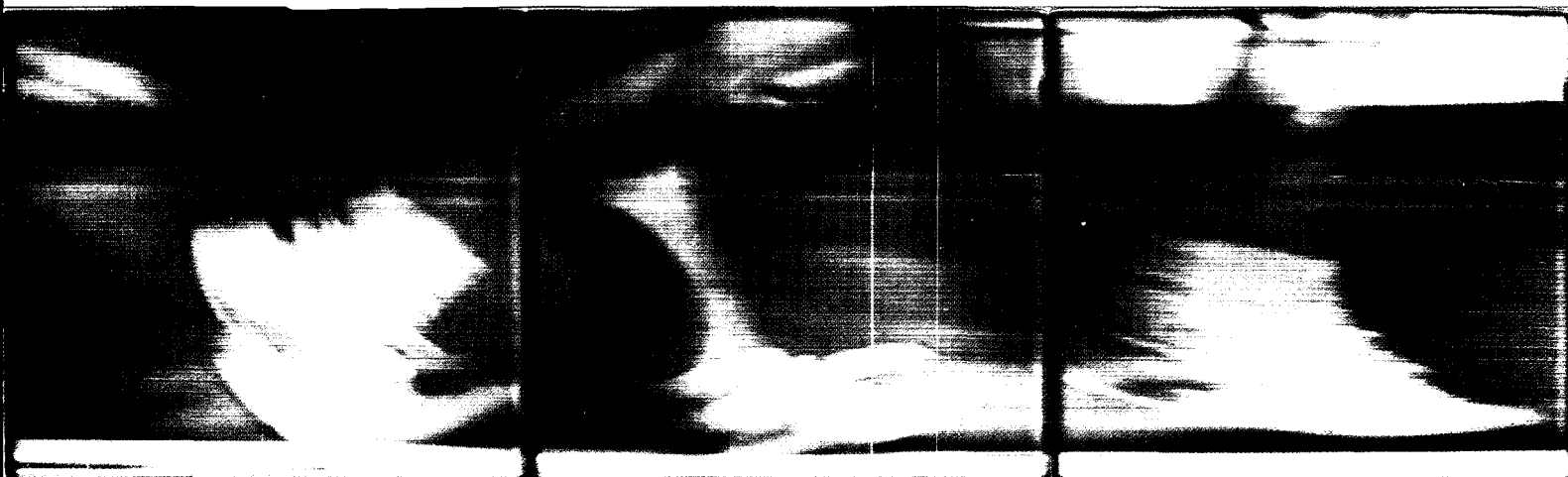


02029007

*AR/S
RE 12/31/01*

REC'D S.E.C.

MAR 29 2002



Momentum

2001 Annual Report

PROCESSED

APR 03 2002

THOMSON
FINANCIAL *p*

Momentum

Physics. A measure of the motion of a body equal to the product of its mass and velocity.

Through the turbulence that was 2001, Document Sciences Corporation's momentum carried it smoothly and steadily forward.

Early in the year, the organization reset its foundation, positioning itself for leadership and innovation in Content Automation. During 2001, a record number of Autograph products were released, important new partnerships were forged and the insurance and financial services industries continued to select Document Sciences' Content Automation solutions for mission-critical customer communications.

All the while, Document Sciences quietly began creating a revolutionary new architecture, designed to take its customers and partners into the next decade – designed to build upon the steady momentum achieved in 2001 with even greater velocity.

Table of Contents

Selected Financial Data	1
Letter to the Stockholders	2
Momentum	4
SEC 10-K	Insert
Corporate Data	Inside Back Cover

Selected Financial Data

(In thousands, except per share data)

Statement of Income	1999	2000	2001
Total revenues	\$ 24,305	\$ 22,579	\$ 22,120
Initial license fees	10,406	10,258	8,200
Annual license fees	7,607	8,621	8,708
Services & other revenue	6,292	3,700	5,212
Income (loss) from operations	1,366	(416)	359
Net income	2,111	531	638
Net income per share	.20	.05	.11
Shares used in per share calculations	10,817	11,154	5,831
Research & development expenditures, gross	5,322	5,345	5,920

Balance Sheet

Year Ended December 31, 2001

Cash, cash equivalents & short-term investments	\$ 8,923
Accounts receivable & due from affiliates	6,768
Other assets	4,015
Total assets	<u>\$ 19,706</u>
Deferred revenue	\$7,986
Notes	2,425
Other liabilities	1,595
Stockholders' equity	7,700
Total liabilities & stockholders' equity	<u>\$ 19,706</u>

LETTER TO THE STOCKHOLDERS

To Our Stockholders:

Year 2001: Reset the Foundation

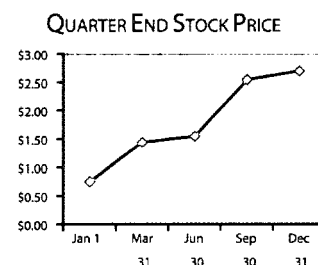
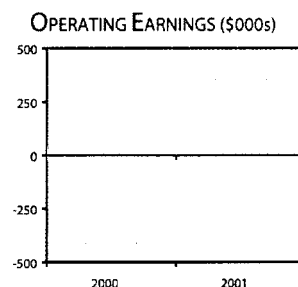
The year 2001 was a significant success in many respects for Document Sciences Corporation. The year started with the introduction of a new executive management team – myself, Executive Vice President Dan Fregeau and Vice President of Sales Doug Pike – committed to building long-term value in Document Sciences. As a first order of business, we undertook actions, both financial and operational, to reset the foundation of the company. Our intent was to build a new platform for unleashing Document Sciences' potential and our actions initiated a three-step, three-year process to move the company into a position of technological leadership and consistent value creation.

The Right Financial Moves

From a financial perspective, we undertook actions that allowed us to improve profitability, despite the overall economic weakness during 2001, and position our company favorably for the future.

Acknowledging the fact that, as we entered the year, the outlook for the world economy was not strong, we proactively took steps to reduce our expense run rate. We decreased costs by over 5%, which enabled us to grow our operating earnings in 2001 by over \$750,000, and to provide benefits carrying over into 2002.

We also undertook a significant share repurchase through a formal self-tender process, reducing our outstanding shares by 66% from 10.8 million to 3.8 million. Our improved operational profit performance, coupled with our remaining shareholders' increased stake in our earnings following the repurchase, helped power our stock up by 260% during the year.



Sound Operations

From an operational perspective, our main objectives were to retain operational effectiveness while reducing costs and concurrently maintaining our commitment to Research & Development investments. We were successful on both counts. Through effective use of our resources and the high standards of our managers and employees, we were able to deliver high client satisfaction in terms of consultative sales, implementation services, post-sales technical support and administration. We have the right people and processes in place to ensure highly positive customer experiences as we move forward.

Commitment to Research & Development

While we reduced costs in other areas of the company, expenditures on Research & Development increased by 11% and represented 27% of our revenue. We delivered several new products during 2001 — including Output Processing for distribution efficiency, VPS for increased color printing

performance and Web Designer for presentment of content in both print and web formats through the use of a single application — further bolstering our enterprise suite of Content Automation functionality.

Just as significantly, we made great strides in the development of our next generation architecture project. The market is demanding software that is highly scalable, secure and able to easily interface with other products or components. Additionally, we believe that an effective customer communications strategy requires the ability to effectively present information in a variety of modes, to address the increasing range of customer touch points – for example, printed documents, e-mail and Internet browser displays. Our new architecture is being developed to meet these requirements. It is Java-based, built to operate in the enterprise-strength J2EE environment and takes advantage of open standards such as XML to enable connectivity with complementary software.

*Emphasis on Partner
Relationships*

Our next generation architecture, developed for optimized integration, heightens the emphasis that we are placing on partnerships. During 2001, we successfully engaged a number of technology and systems integration partners and we plan to tactically engage other partners during 2002. On the technology side, we signed partnership arrangements with several software companies that touch the Content Automation process and with whom Document Sciences can work to provide broader solutions to customers, including database players Oracle and Sybase, CRM's Siebel Systems, FileNET in the content management area and insurance administration vendor AscendantOne. We also signed partnership agreements with American Management Systems and Edgewater Technology, proven systems integrators that provide the glue to ensure that Document Sciences' products perform effectively with those of our technology partners.

*Year 2002:
Transition to
Leadership*

We firmly believe that we are on the path to becoming the leader in Content Automation and the groundwork laid during 2001 prepares us well for the challenges we will face moving forward. An emphasis on profitability will continue as the basis for building shareholder value. At the same time, we regard heavy investment in Research & Development and partnership activities, particularly related to our new architecture, as critical to our ability to provide long-term returns to our shareholders.

On behalf of all Document Sciences' employees, I express my appreciation for our shareholders' continued support as we strive for Content Automation leadership.

Sincerely,



John L. McGannon

President, Chief Executive Officer and Chief Financial Officer

MOMENTUM

The Momentum Continues

2001 marked a decade since Document Sciences Corporation first revolutionized the production of mission-critical customer communications through its Autograph technology. We enter our eleventh year with great momentum and the introduction of a new open software architecture that will take both our current Autograph customers and future customers forward for years to come.

Based on a strong understanding of the business challenges facing our customers and an incisive knowledge of enterprise information technology, this new architecture takes Content Automation to an entirely new level with unsurpassed connectivity, flexibility and performance. We call this new open architecture **xPression™**.

Key features of the new architecture include:

- **Java 2 Enterprise Edition (J2EE) Component Design** – Adherence to J2EE specifications enables xPression to integrate and interact with an enterprise's existing technology solutions. Connector software makes seamless integration of CRM solutions, workflow systems and other enterprise technology easier than ever to achieve. Using J2EE connectors, an insurance company, for example, will be able to easily launch Document Sciences' enterprise Content Automation system from within a J2EE-enabled enterprise CRM system to deliver fully compliant insurance policies and quotes.
- **Fully Integrated XML** - This tag-based language for defining data elements on Web pages and within business documents is rapidly becoming the standard for Electronic Data Interchange. Unlike HTML tags,

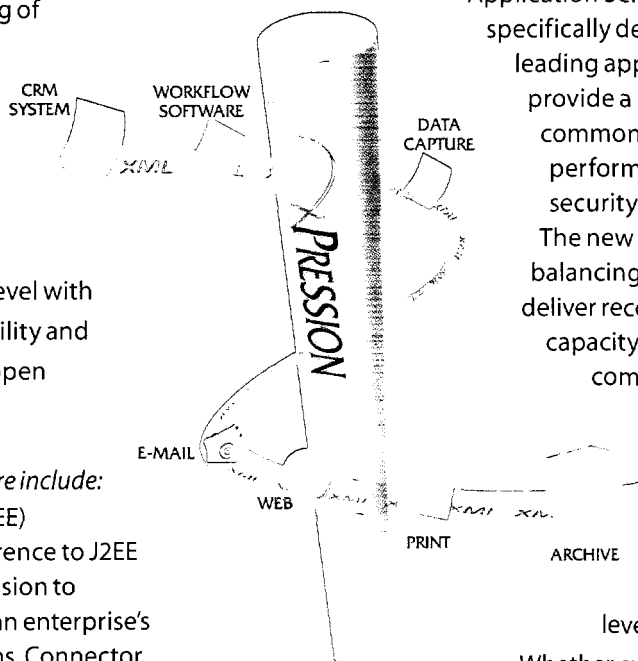
which only focus on how content looks, XML intelligently defines the actual data structure. With full XML input and output capability, Document Sciences' xPression will provide unsurpassed flexibility in creating content from an organization's myriad of data sources while composing that content for optimal presentation and delivery via nearly any communication channel.

- **Application Server Deployment** – xPression will be specifically designed to run on the world's leading application servers. These servers provide a runtime environment and a set of common services that enable optimal performance, reliability, integration and security for mission-critical applications. The new architecture will feature load balancing and fault-tolerance capability to deliver record-setting speed, scalability and capacity for batch and transactional composition and delivery of mission-critical customer communications.

For Document Sciences' current customers, xPression's compatibility offers a new way to leverage their Autograph infrastructure.

Whether customers are thinking, planning or in the process of implementing J2EE enterprise technology running on application servers, xPression's open architecture will facilitate easy integration of existing Autograph applications. For new Document Sciences customers, xPression will provide a "here and now" Content Automation alternative that seamlessly integrates with "best of breed" enterprise solutions, including CRM systems, workflow software, data capture and archive solutions and more.

In 2002, with the introduction of xPression, our momentum continues...and the possibilities are wide open.



SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

- ☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2001

or

- ☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 0-20981

Document Sciences Corporation

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

33-0485994

*(I.R.S. Employer
Identification No.)*

6339 Paseo del Lago, Carlsbad, California

(Address of principal executive offices)

92009

(Zip code)

Registrant's telephone number, including area code: (760) 602-1400

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$.001 par value per share

(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

As of February 28, 2002, there were 3,869,364 shares of the Registrant's common stock outstanding and the aggregate market value of such shares held by non-affiliates of the Registrant (based upon the closing sale price of such shares on The Nasdaq National Market on February 28, 2002) was \$7,375,355. Shares of common stock held by each executive officer and director and by each entity that owns 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from Registrant's definitive proxy statement pursuant to Schedule 14A for its 2002 Annual Meeting of Stockholders to be held on April 23, 2002, which proxy statement will be filed no later than 120 days after the close of Registrant's fiscal year ended December 31, 2001.

TABLE OF CONTENTS

	<u>Page</u>
A Warning About Forward-Looking Statements	1
PART I	
Item 1 Business	1
Item 2 Properties	12
Item 3 Legal Proceedings	12
Item 4 Submission of Matters to a Vote of Security Holders	12
PART II	
Item 5 Market for Registrant's Common Equity and Related Stockholder Matters	13
Item 6 Selected Financial Data	13
Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 7A Quantitative and Qualitative Disclosures About Market Risk	18
Item 8 Financial Statements and Supplementary Data	18
Item 9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosures	19
PART III	
Item 10 Directors and Executive Officers of the Registrant	19
Item 11 Executive Compensation	20
Item 12 Security Ownership of Certain Beneficial Owners and Management	20
Item 13 Certain Relationships and Related Transactions	20
PART IV	
Item 14 Exhibits, Financial Statement Schedules and Reports on Form 8-K	20
Signatures	21
Financial Statements	F-1

(This page intentionally left blank)

A WARNING ABOUT FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this Annual Report that are subject to risks and uncertainties. These forward-looking statements include information about possible or assumed future results of our financial condition, operations, plans, objectives and performance. Additionally, when we use the words "believe," "expect," "anticipate," "estimate" or similar expressions, we are making forward-looking statements. Many possible events or factors could affect our future financial results and performance. This could cause our results or performance to differ materially from those expressed in our forward-looking statements. You should consider these risks when you review this document, along with the following possible events or factors:

- national, international, regional and local economic, competitive and regulatory conditions and developments;
- the market for document automation software;
- market acceptance of enhancements to our existing products and introduction of new products;
- continued expansion of our professional services;
- maintaining our relationships with Xerox Corporation; and
- other uncertainties, all of which are difficult to predict and many of which are beyond our control.

Foreseeable risks and uncertainties are described elsewhere in this report and in detail under "Item 1. Business — Risk Factors." You are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date of this Annual Report. We undertake no obligation to publicly release the results of any revision of the forward-looking statements.

PART I

Item 1. *Business*

Document Sciences Corporation develops, markets and supports a family of document automation software used in high volume print and transactional electronic publishing applications. Document automation has become increasingly important as more companies realize the benefits of producing personalized documents that include the precise layout of regulated content, personal financial data and in-context, one-to-one marketing information. Our document automation software (our *Autograph* family of products) enables personalized publishing solutions for many industries including insurance, managed healthcare, financial services, commercial print services, government, telecommunications and manufacturing. Our products facilitate an important form of communication between organizations and their customers by employing enterprise database assets to produce high-quality, highly-personalized documents that are ready to print on demand, to email or to distribute over the web using HTML or Adobe Systems' (Adobe) PDF® technology. Our *Autograph* products are licensed to approximately 600 customers worldwide who collectively produce over one billion customized pages per month. Our highly portable *Autograph* software platform enables cost-effective, just-in-time, on demand, high volume or transactional publishing that is high quality and fully automated. Our software products are used across a wide array of computing environments from client/server PC and Unix configurations to large mainframe computer systems.

Company Formation

We were incorporated in Delaware in October 1991 as a wholly owned subsidiary of Xerox Corporation (Xerox). Following our initial public offering of stock in September 1996, Xerox ownership was reduced to approximately 62%. As a result of our tender offer and our exercise of an option to purchase additional shares from Xerox in April 2001, Xerox's ownership interest has been reduced to 19.9%. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources".

Products

Our *Autograph* family of products currently addresses two major functional areas within the enterprise content and document automation arena: Document Composition and Assembly and Regulated Content Management. All of our software products can be complemented by our professional services organization.

We generally license our products for one year, for an initial license fee, after which an annual renewal license and support fee, usually 15% of the initial license fee, is required for continued use. We have two additional licensing models whereby we offer perpetual licenses for our products, as well as three-year term licenses, after which the license may be renewed for additional three-year terms, or converted for perpetual use. We also provide three-year maintenance agreements that are usually in an amount equal to 15% per year of the initial license fee. The list price for a three-year license fee for CompuSet, our core product, is currently \$90,000 for a mainframe installation and ranges down to \$45,000 for a PC NT server installation. Options currently range from \$2,000 to \$50,000. A typical new account sale through our direct channel is approximately \$100,000 for software licenses and \$75,000 for professional services.

Document Composition and Assembly

Composition and Assembly. CompuSet software automates document composition and assembly using corporate data and variable content. CompuSet consists of a rule-based language and a robust composition engine that provides high-speed content composition and assembly of complex personalized documents at a high level of quality. Corporate data and variable content are marked with CompuSet tags which, in turn, are defined in logically separate CompuSet style specifications. The CompuSet tags are conceptually and syntactically similar to HTML or XML tags, the current web standards for content tagging, and the CompuSet style specifications are conceptually similar to CSS and XSL, the current web standards for style definition. Without requiring any real-time user interaction, CompuSet transforms the tagged data, the style specifications and the variable content into high-quality electronic documents that are assembled and composed at rates in excess of 50 pages per second, depending on the computing platform configuration and the complexity of the document. The document composition features are rich and extensive, including the automatic generation of multi-dimensional dynamic data driven graphics and the support of full color text and images. The composition and assembly process can be optimized for print, email and/or web presentation media for multi-channel distribution.

Document Output and Merge. The CompuSet Emitters transform CompuSet generated output into a number of popular Page Description Languages (PDLs) for subsequent printing, electronic distribution and/or archive storage for future retrieval and viewing. These PDLs provide device-specific instructions for rendering text, forms, images and graphics into finished documents. The Emitters also condition the PDLs for transport over a variety of high-speed printing interfaces and for support of various finishing devices. The PDL formats currently supported are Xerox' Metacode®, International Business Machines Corporation's (IBM) AFPDS®, Hewlett-Packard Company's PCL® and Adobe's PostScript® and PDF. This part of the *Autograph* architecture is extensible and new Emitters can be developed as necessary. In 2001, we significantly extended our architecture with the release of Output Processing. Output Processing enables inline output stream manipulation including stream splitting, merging, resequencing, sorting, bundling and barcoding. These features are necessary for postal optimization, for the support of finishing equipment without further post-processing and for multi-channel applications that require both print and electronic (email) distribution. In addition, several additional Emitter extensions were released, including support for Creo's Variable Print Specification® (VPS), enabling high-volume full-color production on Xerox DocuColor products, as well as additional extensions for IBM's AFPDS® and Adobe's PDF®.

Rapid Application Development Tools. The Visual CompuSet application development tools run on Microsoft Corporation's (Microsoft) Windows® and simplify variable document application design and prototyping. Visual CompuSet uses a Windows® version of CompuSet that supports all of the composition features of the NT, Unix and mainframe CompuSet production engines to ensure exact design for all supported production platforms. Visual CompuSet includes a variety of content Importer, Merge, Font and Emitter tools necessary for basic application development. The content Importers accept externally generated

document content, including text and forms, static graphics and scanned images, and converts them into CompuSet compatible formats. The content Importers currently support merge content in Xerox Metacode®, Adobe PostScript® and EPS® and in the TIFF and JPEG standards for scanned images. This part of the *Autograph* architecture is extensible and new content Importers can be developed as necessary. Visual CompuSet also provides an extensible and easy-to-use Graphical User Interface (GUI) platform for our optional Data Preparation Tool and Professional Edition product options as described below.

Data Preparation Tool. The Data Preparation Tool (DPT) is a Visual CompuSet product extension that enables users to map, capture, edit and tag corporate data and variable content from a wide variety of sources, including flat files and popular relational databases. It provides an easy-to-use GUI that enables the description of a complex variable data environment including any related data processing and tagging instructions. Using a data description, it automatically generates a COBOL data-tagging program that is compatible with mainframe COBOL compilers and with Acucorp's AcuCobol® runtime products on Unix and NT platforms. DPT eliminates the need to manually develop and maintain custom programs for capturing, processing and tagging corporate data used to drive personalized document assembly and composition. DPT is the production engine for applications that are developed using our fully integrated design tool, Visual CompuSet Professional Edition.

Visual CompuSet Professional Edition. Visual CompuSet Professional Edition (VCPro) significantly augments the capabilities of the Visual CompuSet and DPT products through the addition of an interactive Document Designer component that is tightly integrated with the DPT GUI. VCPro users can define their data environment with DPT and can directly associate their data and variable content elements with CompuSet style specifications such as sections, paragraphs, tabular elements, images, photographs and data-driven graphics. The VCPro Document Designer GUI features WYSIWYG interaction and drag-and-drop operability. The feature set is optimized for the generation of high-value investment and financial statements. In 2001, we released VCPro Web Designer, a new product option that enables the parallel development of HTML portal applications using the same DPT data environment as a related print application. In a single GUI, users are able to design an application for both print and real-time web distribution. For example, an investment statement designed for traditional print distribution can be easily web-enabled for on-demand interactive web access. The web-enabled application can be integrated into a corporate web portal that provides personalized customer access to individual account information. VCPro Web Designer eliminates the need to develop and maintain duplicate application development environments for both web and print.

Regulated Content Management

Our *Autograph* regulated content management products provide solutions for the creation, revision and management of document content used in several types of regulated document automation applications. They consist of the Document Library Service (DLS) Server and Client products, DLS Express, DLS eCor and DLSCOM. Unlike other general-purpose content management products, our *Autograph* DLS products are tailored for regulated document applications.

DLS Server and Client. DLS Server manages the document content creation process required in complex, regulated text-intensive documents, such as proposals, contracts, policies and customer correspondence. Our DLS products use a client server architecture for accessing data and files stored on mainframes or NT network servers. DLS Client manages the text content created with Microsoft Word® and stored in HTML. The DLS text content is tracked and managed in a multi-authoring environment that supports access security, content searching, revision control and approval workflow. In addition to content creation and management, DLS Client enables the definition of complex assembly and business rules required for interactive or automated document assembly and composition using Microsoft Word® and/or CompuSet. DLS supports a criteria-based content selection mechanism for generating a Microsoft Word® document or a CompuSet tagged file, based on application volume requirements. The personalized document assembly can occur in a high volume fashion on a server or in a just in time, on-demand fashion on a local DLS Client computer.

DLS Express. DLS Express augments the flexibility of our DLS product line by incorporating web support. DLS Express enables the dynamic creation and fulfillment of web-ready documents using HTML and/or Adobe's PDF®. These web documents can be created on-demand through a variety of web server applications including Advanced Server Pages (ASP). Dynamic web browser form input can be routed to the DLS Express server to automatically assemble and generate a customized web-ready document for local browser viewing or for local printing. Target web fulfillment applications for DLS Express include sales proposal and contract automation for insurance and other financial agents.

DLS eCor and DLSCOM. DLS eCor and DLSCOM further augment our DLS technology capabilities by providing a rich feature-set that is targeted at enterprise-wide correspondence applications. DLS eCor enables the on-demand generation of customer correspondence through corporate call centers. DLS eCor is web-based and features an integrated Java editor that can be used to make additional manual or exception changes to pre-assembled customer correspondence. DLS eCor supports an email-based change tracking, approval and workflow process to ensure document integrity and compliance. DLSCOM is a component product version that enables the deployment of our DLS technology in a Microsoft COM/DCOM environment. With DLS eCor and/or DLSCOM, customers can integrate our DLS products into a Customer Relationship Management (CRM) system or electronic CRM system of their choice.

Autograph for the Enterprise

Our products generally are licensed initially for a single document automation application. Regulated content applications such as policies and contracts are typically implemented using our DLS products whereas statement applications are typically implemented using our VCPPro products. In each case, document production is driven through our CompuSet products. A growing number of customers are licensing our entire *Autograph* product suite for use across multiple applications throughout their enterprise.

Professional Services

In addition to our software products, we provide a comprehensive suite of professional services that can assist customers in the implementation of mission-critical document automation applications. Our professional services include on-site software installation, consulting services, customer training programs and telephone support. Our consulting services focus on assisting in the sale of high margin initial software licenses by providing project management, requirements analysis, application design and application development services. In addition to consulting services, we provide introductory and advanced-level education classes in CompuSet, Visual CompuSet, DPT, VCPPro and DLS at our headquarters in San Diego, our offices in Milwaukee and Washington DC and at customer sites. We believe our professional services enable customers to use our document automation products rapidly and effectively. Our professional services and support organizations employed a staff of 41 as of December 31, 2001.

Sales and Marketing

Our sales and marketing organization targets vertical industry markets that require document automation and high volume, high quality document personalization. We currently license our products using a combination of direct sales and alternative channels. In the United States, we market our products primarily through a direct sales force that manages our existing base of corporate accounts, as well as targets new accounts in select market segments. Our sales account executives are provided with pre-sales technical support through qualified solution analysts. Account executives and solution analysts are located throughout the United States to provide optimal coverage. Outside of the United States, we distribute our software products through value added resellers (VARs) such as Xerox Canada, Ltd. in Canada, Fuji Xerox Co., Ltd. in Australia and Xerox do Brazil, Ltd. in Brazil. Our subsidiary, Document Sciences Europe, markets our products in Europe, Africa and the Middle East by providing VAR channel management and support and by defining European market and product requirements. Our European VARs are principally Xerox Europe affiliates who re-market our products. Our revenues from export transactions with Xerox affiliates were \$4.6 million, \$4.7 million and \$3.7 million in 1999, 2000 and 2001, respectively. Our sales and marketing organization employed a staff of 36 as of December 31, 2001.

We intend to increase both our product offerings and markets through joint marketing, sales and distribution and development relationships with other major companies. Current relationships include formal and informal marketing and sales alliances with IBM, Xerox, American Management Systems, Inc. and Edgewater Technology, Inc. These relationships provide qualified sales leads for our products and extend our sales coverage and networking capabilities. In addition, we also support partner relationships with complementary technology companies such as Siebel Systems, Inc., Sybase, Inc. and Oracle Corporation. We participate in joint marketing events with our key partners whenever appropriate and feasible. Furthermore, we actively market our products and solutions at major trade shows, through focused regional seminars and through a variety of web marketing mechanisms, including webinars.

Research and Development

We are continuing to enhance our web functionality across all of our major product offerings. We engage customers in a formal requirements analysis that is based on the Quality Function Deployment (QFD) process. The QFD process is a formal procedure for interviewing customers, identifying their needs and prioritizing specific product features. As a result, we have identified a number of customer requirements for the production of regulated, electronic documents for the future. Our major development initiatives in 2002 address several of these key requirements brought to our attention through our QFD process.

In general, our product development strategy is based on delivering document automation solutions for specific types of documents in one or more vertical markets or industries. A cross-functional team is responsible for delivering each focused offering. We use a documented business planning and product delivery process to guide our product development and delivery activities. We also employ iterative and rapid prototyping development methodologies.

Our recent product offerings continue to build on our existing *Autograph* family of products. These well-established products are maintained by teams that respond to customer requests for defect corrections and feature enhancements. By building on our existing products, we maximize our reuse of existing software and expertise and we enable our customers to purchase these new offerings as upgrades to their existing product configurations.

Future new product offerings are being developed as components that adhere to open standards for large-scale systems integration. Furthermore, these product offerings will be supporting open tagged data and content standards such as XML. By developing products using open standards, we can expand the delivery of our products through large systems integrators and other channels.

We can make no assurance that we will be successful in developing, introducing and marketing future new products on a timely and cost-effective basis, if at all, or that such future new products will achieve market acceptance. See "Risk Factors — Our growth depends on market acceptance of enhancements to our existing products and our introduction of new products."

We expect to continue enhancing our existing products and to develop future new products, particularly as they relate to multi-channel content automation applications. Our research and development expenditures have grown substantially since our inception. Such expenditures, not including amounts capitalized, were \$5.3 million, \$5.3 million and \$5.9 million in 1999, 2000 and 2001, respectively. Our development organization employed a staff of 40 as of December 31, 2000. We also utilize outside consulting and development firms and employ independent contractors as needed to supplement our permanent development staff.

Competition

The market for document automation products is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. We target document intensive organizations that require the ability to produce large quantities of personalized documents in paper or electronic form. We face direct and indirect competition from a broad range of competitors who offer a variety of products and solutions to our current and potential customers. Our principal competition currently comes from systems developed in-house by the internal MIS departments of large

organizations where there is a reluctance to commit the time and effort necessary to convert their existing document automation processes to our document automation software. We also face competition from Docucorp International, Inc., in the insurance industry, Metavante in banking and financial services, Group 1 Software, Inc. in commercial direct mailing and marketing, as well as numerous other smaller competitors. Several of our competitors have longer operating histories, significantly greater financial, technical and marketing resources, greater name recognition and a larger base of established customers. We believe that the principal competitive factors affecting our market include product performance and functionality, ease of use, scalability, operating across multiple computer and operating system platforms, product and company reputation, client service and support and price.

It is also possible that we will face competition from new competitors. These include large independent software companies offering personal computer-based application software solutions, such as Microsoft and Adobe, and from large corporations providing database and content management software solutions, such as Oracle Corporation. In addition, Xerox or IBM, either directly or through affiliated entities, could become large competitors. Moreover, as the market for document automation software develops, a number of these or other companies with significantly greater resources could attempt to enter or increase their presence in the document automation market by either acquiring or forming strategic alliances with our competitors or by increasing their focus on the industry. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our current and prospective customers. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, operating results and financial condition.

Patents and Proprietary Rights

Our success is dependent, in part, on our ability to protect our proprietary technology. We rely primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We seek to protect our software, documentation and other written materials under trade secret and copyright laws. However, these afford only limited protection. We presently have no patents or patent applications pending. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. See "Risk Factors — Our growth is dependent upon successfully protecting our proprietary rights."

In addition, we also rely on certain software that we license from third parties, including software that is integrated with internally developed software and used in our products to perform key functions. There can be no assurances that such firms will remain in business, that they will continue to support their products or that their products will otherwise continue to be available to us on commercially reasonable terms. The loss or inability to maintain any of these software licenses could result in delays or reductions in product shipments until equivalent software can be developed, identified, licensed and integrated, which would adversely affect our business, operating results and financial condition.

Customers

We derived 19% of our revenues through Xerox and its affiliates in 2001. As a result, discontinuation of agreements and other business transactions that may adversely impact our relationship with Xerox could have a material adverse effect on our business, operating results and financial condition.

Employees

As of December 31, 2001, we had 130 employees including 41 in professional services, 36 in sales and marketing, 40 in research and development and 13 in finance and administration. None of our employees are represented by labor unions. We have experienced no work stoppages and believe our relationship with our employees is good. Competition for qualified personnel in the industry in which we compete is intense. We

believe that our future success will depend in part on our continued ability to attract, hire and retain qualified personnel.

Financial Information about Segments and Geographic Areas

The information regarding revenues and operating profit by reportable segments and revenues from unaffiliated customers by geographic region is set forth at the end of the Annual Report under the heading "Notes to Consolidated Financial Statements — 3. Segment Information," and is incorporated herein by reference.

RISK FACTORS

The following is a discussion of certain factors which currently impact or may impact our business, operating results and/or financial condition. Anyone making an investment decision with respect to our common stock or other securities is cautioned to carefully consider these factors. If any of the following risks actually occur, our business, future operating results and financial condition could be materially adversely affected. In such case, the trading price of our common stock could decline and you may lose all or part of your investment.

Our quarterly results fluctuate significantly and we may not be able to grow our business.

Our total revenues and operating results can vary, sometimes substantially, from quarter to quarter, and we expect them to vary significantly in the future. Our revenues and operating results are difficult to forecast, and our future results will depend upon many factors, including the following:

- the demand for our products;
- the level of product and price competition we face;
- the length of our sales cycle;
- the size and timing of individual license transactions;
- the delay or deferral of customer implementations;
- the budget cycles of our customers;
- our success in expanding our direct sales force or indirect distribution channels;
- the timing of our new product introductions and enhancements, as well as those of our competitors;
- our mix of products and services;
- our level of international sales;
- the activities of and acquisitions by our competitors;
- our timing of new hires;
- changes in foreign currency exchange rates;
- our ability to develop and market new products and to control costs; and
- general domestic and international economic conditions.

Our initial license fee revenue mainly depends on when orders are received and shipped. However, because of our sales model, our customers' implementation schedule and the complexity of the implementation process, revenue from some software shipments may not be recognized in the same quarter as when shipment occurs. Our operating expenses are primarily based on anticipated revenue levels. Since a high percentage of those expenses are relatively fixed, a delay in the recognition of revenue from license transactions could cause significant variations in operating results from quarter to quarter and we may sustain losses as a result. If such expenses precede increased revenues, our operating results would be materially adversely affected.

As a result of these factors, results from operations for any quarter are subject to significant variation, and we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and

should not be relied upon as an indication of our future performance. Furthermore, our operating results in some future quarter may fall below the expectations of public market analysts and investors. If this occurs, the price of our common stock would likely be materially adversely affected.

We currently derive a significant portion of our revenues through Xerox.

We currently have a variety of contractual and informal relationships with Xerox and its affiliates, including a cooperative marketing agreement, a transfer and license agreement and various distribution agreements. We rely on these relationships and agreements for a significant portion of our total revenues. In 2001, revenues derived from relationships with Xerox and affiliates of Xerox accounted for approximately \$5.2 million, \$5.2 million and \$4.1 million in 1999, 2000 and 2001, respectively, representing 21%, 23% and 19% of our total revenues, respectively.

Furthermore, there can be no assurance that existing and potential customers will continue to do business with us because of these relationships or our historical ties with Xerox and its affiliates. Although we intend to continue our existing business relationships with Xerox, our strategy is to lessen our dependence on Xerox. However, there can be no assurance that we will be able to do so and, because of our current level of dependence on Xerox, there can be no assurance that our move to become more independent will not adversely affect our business, operating results and financial condition. Our failure to maintain these relationships, particularly with Xerox and its affiliates, or to establish new relationships in the future, could have a material adverse effect on our business, operating results and financial condition.

Xerox has strategic alliances and other business relationships with other companies who supply software and services used in high volume electronic publishing applications and who now or in the future may be our competitors. There can be no assurance that Xerox or one of its affiliated companies will not engage in business that directly competes with us. In addition, Xerox has ongoing internal development activities that could in the future lead to products that compete with us. Xerox could in the future expand these relationships or enter into additional ones and, as a result, our business could be materially adversely affected.

Our growth is dependent upon successfully protecting our proprietary rights.

We rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. Despite these precautions, it may be possible for unauthorized third parties to copy portions of our products or use information we consider proprietary. Policing unauthorized use of our products is difficult and, while we are unable to determine the extent to which piracy of our software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

We are not aware of any infringement of our products upon the proprietary rights of third parties. However, we cannot assure you that third parties will not claim infringement by us with respect to current or future products. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results and financial condition.

Our growth is dependent upon successfully focusing our distribution channels.

We intend to streamline our worldwide sales and distribution channels by focusing on key target industry market segments where our current and planned products enjoy a significant competitive advantage and a current, high market demand. We also plan on leveraging our existing relationships with Xerox, IBM and their channels and affiliates by launching targeted joint marketing and value added reseller programs and by

introducing new product offerings that are optimized for selected target markets and marketing channels. In addition, we intend to form additional partnerships with system integrators and consultants in order to broaden our capacity to deliver complete document automation solutions that incorporate significant services content, while also maintaining our core domain expertise. We cannot assure you that we will be able to successfully streamline and focus our worldwide channels, leverage our existing relationships or form new alliances. If we fail to do so, it will have a material adverse effect on our business, operating results and financial condition.

Maintaining our professional services expertise is necessary for our future growth.

We are continuing our focus on the consulting services component of our professional services to assist customers in the planning and implementation of enterprise-wide, mission-critical document automation applications. This strategy is dependent on retaining and hiring professionals to perform these consulting services. Should we be unable to maintain the necessary services workforce, our business and financial condition could be materially adversely affected.

Our growth depends on our ability to compete successfully against current and future competitors.

The market for document automation products is intensely competitive. We face competition from a broad range of competitors, many of whom have greater financial, technical and marketing resources than we do. Our principal competition currently comes from systems developed in-house by the internal MIS departments of large organizations and direct competition from numerous software vendors, including Docucorp International, Inc., Metavente and Group 1 Software, Inc. We believe that the principal competitive factors affecting our market include product performance and functionality, ease of use, scalability, operating across multiple computer and operating system platforms, product and company reputation, client service and support and price. Although we believe that we currently compete favorably with respect to such factors, we cannot assure you that we will be able to maintain our competitive position against current and future competitors, especially those with greater financial, technical and marketing resources than us, or that we will be successful in the face of increasing competition from new products, new solutions introduced by existing competitors or by new companies entering the market.

Our growth depends on market acceptance of enhancements to our existing products and our introduction of new products.

Our future business, operating results and financial condition will depend upon market acceptance of our existing products, as well as our ability to respond to emerging industry standards and practices and to develop new products that address the future needs of our target markets. Our *Autograph* family of products has been applied mainly to document automation applications producing paper-based documents. We have started to extend our core technology to the Internet, intranets and commercial on-line services. However, we cannot assure you that we will be successful in developing, introducing and marketing new products or product enhancements, including new products or the extension of existing products for the Internet, intranets and commercial on-line services, on a timely and cost effective basis, if at all. In addition, we cannot assure you that our new products and product enhancements will adequately meet the requirements of the marketplace or achieve market acceptance. Delays in our commercial shipments of new products or enhancements may result in client dissatisfaction and a delay or loss of product revenues.

If for technological or other reasons we are unable to develop and introduce new products or enhancements of existing products in a timely manner in response to changing market conditions or client requirements, then our business, operating results and financial condition will be materially adversely affected. In addition, we cannot assure you that our existing products, new products or new versions of our existing products will achieve market acceptance. In order to provide our customers with integrated product solutions, our future success will also depend in part upon our ability to maintain and enhance relationships with our technology partners.

A longer than expected sales cycle may affect our revenues and operating results.

The licensing of our software products often involves an enterprise-wide decision making process by potential customers. Sales cycles generally range from three to twelve months in order to educate potential customers regarding the use and benefits of our products. In addition, the implementation of our products by customers involves a significant commitment of their resources over an extended period of time and is commonly associated with substantial customer business process reengineering efforts. For these and other reasons, our sales and customer implementation cycles are subject to a number of significant delays over which we have little or no control. Any delay in the sale or customer implementation of a limited number of license transactions could have a material adverse effect on our business and financial condition and cause our operating results to vary significantly from quarter to quarter.

Our operating results are substantially dependent on sales of a small number of products in highly concentrated industries.

We derived 66% of our initial license revenue from CompuSet and related CompuSet option products in 2001. In 2001, our initial license fees from DLS and Electronic Document Viewing products comprised 33% and 1%, respectively. As a result, factors that may adversely impact the pricing of or demand for CompuSet and related products, such as competition from other products, negative publicity or obsolescence of the hardware or software environments in which our products run, could have a material adverse effect on our business, operating results and financial condition. Our financial performance will continue to depend significantly on the successful development, introduction and customer acceptance of new and enhanced versions of our CompuSet software and related products.

Our revenues are derived from sales to a small number of industries. Licenses to end users in the insurance, finance and commercial print services industries accounted for 82%, 90% and 97% of initial license revenues in 1999, 2000 and 2001, respectively.

Our future success will depend on our ability to continue to successfully market our products in these and other industries. We cannot assure you that we will continue to be successful in developing and marketing CompuSet products and related services. Our failure to do so would have a material adverse effect on our business, operating results and financial condition.

We may be exposed to risks associated with international operations.

Our revenues from export sales, including sales through our foreign subsidiary, accounted for 25%, 28% and 21% of our total revenues in 1999, 2000 and 2001, respectively.

Our wholly owned subsidiary, Document Sciences Europe, markets and supports our products in Europe. We license our products in Europe through VAR's and to a much lesser extent, direct sales. Our VARs are principally Xerox affiliates who re-market our products. Revenues generated through European resellers were \$3.7 million, \$3.9 million and \$2.7 million in 1999, 2000 and 2001, respectively. In Canada, Australia and Brazil, we distribute our products through Xerox Canada, Ltd., Fuji Xerox Co., Ltd. and Xerox do Brazil, Ltd., respectively. Revenues generated by these Xerox affiliates were \$2.4 million, \$2.4 million and \$2.1 million in 1999, 2000 and 2001, respectively. In order to successfully expand export sales, we may need to establish additional foreign operations, hire additional personnel and develop relationships with additional international resellers. If we are unable to do so in a timely manner, our growth in international export sales could be limited and our business, operating results and financial condition could be materially adversely affected. In addition, we cannot assure you that we will be able to maintain or increase international market demand for our products.

Additional risks inherent in our international business activities include:

- currency fluctuations;
- unexpected changes in regulatory requirements;
- tariffs and other trade barriers;

- our limited experience in localizing products for foreign countries;
- lack of acceptance of our localized products in foreign countries;
- longer accounts receivable payment cycles;
- difficulties in managing our international operations;
- potentially adverse tax consequences including restrictions on the repatriation of earnings; and
- the burdens of complying with a wide variety of foreign laws.

A portion of our business is conducted in currencies other than the U.S. Dollar, primarily the Euro. Although exchange rate fluctuations have not had a significant impact on us, fluctuations in the value of the currencies in which we conduct our business relative to the U.S. Dollar could cause currency transaction gains and losses in future periods. We do not currently engage in currency hedging transactions, and we cannot assure you that fluctuations in currency exchange rates in the future will not have a material adverse impact on our international revenues, business, operating results and financial condition.

Our business is dependent on the market for document automation software.

The market for document automation software is intensely competitive, highly fragmented and subject to rapid change. We cannot assure you that the market for document automation software will grow or that, if it does grow, organizations will adopt our products. We have spent, and intend to continue to spend, significant resources educating potential customers about the benefits of our products. However, we cannot assure you that such expenditures will enable our products to achieve further market acceptance. Moreover, if the document automation software market fails to grow or grows more slowly than we currently anticipate, our business, operating results and financial condition would be materially adversely affected.

In addition, the commercial market for document automation of electronic documents designed for use with the Internet, intranets and commercial on-line services has only recently begun to develop, and the success of our products designed for these markets will depend in part on the compatibility of our products with such services. It is difficult to predict whether the demand for related products and services will increase or decrease in the future. Since the increased commercial use of the Internet, intranets and commercial on-line services could require substantial modification and customization of certain of our products and services as well as the introduction of new products and services, we cannot assure you that we will be able to effectively or successfully compete in this market.

Our ability to manage future change will affect our business.

Our ability to compete effectively and to manage future change will require us to continue to improve our financial and management controls, reporting systems and procedures on a timely basis and to expand, train and manage our work force. We cannot assure you that we will be able to do so successfully. Our failure to do so could have a material adverse effect on our business, operating results and financial condition.

Our executive officers and certain key personnel are critical to our business, and these officers and key personnel may not remain with us in the future.

Our future performance depends significantly upon the continued service of our key technical, sales and senior management personnel. Only our President and Chief Executive Officer and our Chief Scientist have signed employment agreements with us. The loss of the services of one or more of our executive officers or key personnel could have a material adverse effect on our business, operating results and financial condition. Our future success also depends on our continuing ability to attract and retain highly qualified product development, sales and management personnel. Competition for such personnel is intense, and there can be no assurance that we will be able to retain our key employees or that we will be able to attract, assimilate or retain other highly qualified product development, sales and managerial personnel in the future.

Our failure to adequately limit our exposure to product liability claims may adversely affect us.

Our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. However, it is possible that the limitation of liability provisions contained in our license agreements may not be effective under the laws of certain jurisdictions. Although we have not experienced any product liability claims to date, sale and support of our products may entail the risk of such claims in the future. A successful product liability claim brought against us or a claim arising as a result of our professional services could have a material adverse effect upon our business, operating results and financial condition.

Our products may suffer from defects or errors.

Our software products are complex and may contain undetected defects or errors when first introduced or as new versions are released. As a result, we could lose or delay recognition of revenues as a result of software errors or defects. In addition, our products are typically intended for use in applications that may be critical to a customer's business. As a result, we expect that our customers and potential customers have a greater sensitivity to product defects than the general market for software products. Although our business has not been adversely affected by any such errors to date, we cannot assure you that, despite testing by us and by current and potential customers, errors will not be found in our new products or releases. If these errors are discovered after the commencement of commercial shipments, it could result in any of the following:

- loss of revenue or delay in market acceptance;
- diversion of our development resources;
- damage to our reputation; or
- increased service and warranty costs.

If any of these events occur, it would have a material adverse effect upon our business, operating results and financial condition.

Item 2. Properties

We lease approximately 21,300 square feet for our principal administrative, sales, marketing, training and research and development facility in Carlsbad, California. This lease expires on February 28, 2005. Our subsidiary in France occupies approximately 2,200 square feet of office space with a renewable lease expiring on April 15, 2004. In addition, our regional office in Milwaukee, Wisconsin occupies approximately 7,500 square feet of office space pursuant to a lease expiring on March 31, 2003. Sales representatives and field technical support personnel operate from their homes.

Item 3. Legal Proceedings

In the ordinary course of business, we may become involved in legal proceedings from time to time. As of February 22, 2002, we were not a party, nor was our property subject, to any material pending legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of fiscal year 2001.

PART II

Item 5. *Market for Registrant's Common Equity and Related Stockholder Matters*

Our common stock is traded on The Nasdaq National Market under the symbol "DOCX." The following table sets forth the range of high and low sales prices of our common stock for the periods indicated, as reported on The Nasdaq National Market System. Such quotations represent inter-dealer prices without retail markup, markdown or commission and may not necessarily represent actual transactions.

	Price Range	
	High	Low
Fiscal 2000		
First quarter ended March 31, 2000	\$6.25	\$2.94
Second quarter ended June 30, 2000	\$4.34	\$2.06
Third quarter ended September 30, 2000	\$2.50	\$1.34
Fourth quarter ended December 31, 2000	\$1.50	\$0.59
Fiscal 2001		
First quarter ended March 31, 2001	\$1.88	\$0.75
Second quarter ended June 30, 2001	\$2.11	\$1.30
Third quarter ended September 30, 2001	\$4.49	\$1.43
Fourth quarter ended December 31, 2001	\$3.40	\$2.30

We had 3,867,906 shares outstanding and 103 record holders of our common stock as of February 27, 2002. We did not make any sales of unregistered stock in 1999, 2000 or 2001. We have not paid dividends on our common stock and do not anticipate paying dividends in the foreseeable future.

Item 6. *Selected Financial Data*

The following table presents selected financial data of Document Sciences Corporation. This historical data should be read in conjunction with the Consolidated Financial Statements and the related notes thereto in Item 8 and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7.

	Years Ended December 31,				
	1997	1998	1999	2000	2001
	(In thousands, except per share data)				
Statement of Operations					
Net revenues	\$19,740	\$ 20,107	\$24,305	\$22,579	\$22,120
Income (loss) from operations	(58)	(10,361)	1,366	(416)	359
Net income (loss)	838	(9,154)	2,111	531	638
Net income (loss) per share	0.08	(0.86)	0.20	0.05	0.11
Shares used in per share calculations	11,013	10,690	10,817	11,153	5,831
Balance Sheet					
Working capital	\$23,896	\$ 14,883	\$16,611	\$17,151	\$ 5,036
Total assets	34,229	30,989	30,423	31,496	19,706
Capital lease obligations, less current portion	52	13	1	—	—
Stockholders' equity	27,691	18,410	20,280	21,134	7,700

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

Overview

We develop, market and support a family of document automation software used in high volume electronic publishing applications. We were incorporated in Delaware in October 1991 as a wholly owned subsidiary of Xerox Corporation. Following our initial public offering of stock in September 1996, Xerox ownership was reduced to approximately 62%. As a result of our tender offer and our exercise of an option to purchase additional shares from Xerox in April 2001, Xerox's ownership interest has been reduced to 19.9%.

Critical Accounting Policies

We believe the following represent our critical accounting policies:

Revenue Recognition. We recognize revenue in accordance with SOP 97-2, *Software Revenue Recognition* and SAB No. 101, *Revenue Recognition in Financial Statements*. Initial license fees are recognized when a contract exists, the fee is fixed and determinable, software delivery has occurred and collection of the receivable is deemed probable. Revenues generated from consulting services are recognized as the related services are performed. However, when such consulting services are deemed to be essential to the functionality of the delivered software product, revenue from the entire arrangement is recognized on a percentage of completion method or not until the contract is completed in accordance with SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, and ARB No. 45, *Long-Term Construction-Type Contracts*.

Our operating expenses are primarily based on anticipated revenue levels. Since a high percentage of those expenses are relatively fixed, a delay in the recognition of revenue from license transactions could cause significant variations in operating results from quarter to quarter and we may sustain losses as a result. Since revenue may not be recognized in the same quarter as when shipment occurs and if such fixed expenses precede these revenues, our operating results would be materially adversely affected.

Computer Software Costs. In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*, costs incurred in the research and development of new software products and significant enhancements to existing software products are expensed as incurred until the technological feasibility of the product has been established. After technological feasibility has been established, direct production costs, including programming and testing, are capitalized until general release of the product.

Capitalized costs of software to be sold, licensed or otherwise marketed are amortized using the greater of the amount computed using the ratio of current period product revenues to estimated total product revenues or the straight-line method over the remaining estimated economic lives of the products. It is possible that estimated total product revenues, the estimated economic life of the product, or both, will be reduced in the future. As a result, the carrying amount of capitalized software costs may be reduced in the future, which could cause our operating results in future periods to be adversely affected.

Results of Operations for the Years Ended December 31, 1999, 2000 and 2001

Revenues

Total revenues were \$24.3 million, \$22.6 million and \$22.1 million in 1999, 2000 and 2001, respectively, representing decreases of 7% from 1999 to 2000 and 2% from 2000 to 2001. Our revenues are divided into three categories based upon the sources from which they are derived: initial license fees, annual renewal license and support fees, and services and other revenues. Initial license fees consist primarily of license fees for the first year of use of our products. Annual renewal license and support fees consist of license fees for the continued use and support of our licensed products. Services and other revenues consist of fees for consulting, application development and training services performed by us as well as miscellaneous other operational revenues.

We sell our products principally through our direct sales force domestically, and internationally through distributors and value added resellers (VARs). Revenues from export sales and sales through our foreign subsidiary were \$6.1 million, \$6.3 million and \$4.7 million in 1999, 2000 and 2001, respectively, representing an increase of 3% from 1999 to 2000 and a decrease of 25% from 2000 to 2001. Revenue from export sales were 25%, 28% and 21% of total revenues in 1999, 2000 and 2001, respectively. The decrease from 2000 to 2001 was the result of lower initial license fees in all regions. The increase from 1999 to 2000 was primarily the result of increased revenues through our Xerox affiliates in Australia and Europe.

We have entered into distributorship agreements with various Xerox foreign affiliates to remarket our products internationally. Our revenues from these agreements were \$4.6 million, \$4.7 million and \$3.7 million in 1999, 2000 and 2001, respectively. The decrease from 2000 to 2001 was the result of lower initial license fees in all regions. The increase from 1999 to 2000 was primarily the result of increased revenues through our Xerox affiliates in Australia and Europe.

Initial license fees. Initial license fees were \$10.4 million, \$10.3 million and \$8.2 million in 1999, 2000 and 2001, respectively, representing decreases of 1% from 1999 to 2000 and 20% from 2000 to 2001. The decreases in 2001 and 2000 were largely the result of fewer sales and fewer new customers from our foreign resellers. Initial license revenues were 43%, 46% and 37% of total revenues in 1999, 2000 and 2001, respectively.

Annual renewal license and support fees. Annual renewal license fees were \$7.6 million, \$8.6 million and \$8.7 million in 1999, 2000 and 2001, respectively, representing increases of 13% from 1999 to 2000 and 1% from 2000 to 2001. The increase in 2001 was largely offset by the impact of discontinuing support for certain products and platforms. These increases in license renewal and support fees were principally due to an increase in the installed base of users of our software products. Annual license fees were 31%, 38% and 39% of total revenues in 1999, 2000 and 2001, respectively.

Services and other. Revenues from services and other were \$6.3 million, \$3.7 million and \$5.2 million in 1999, 2000 and 2001, respectively, representing a decrease of 41% from 1999 to 2000 and an increase of 41% from 2000 to 2001. The increase in 2001 is due to the delivery of consulting services needed to implement new product sales made since the fourth quarter of 2000 as well as significant services to existing customers. The decrease in 2000 was principally due to the mix of software sold, which only required minimal consulting services at implementation. Revenues from services and other were 26%, 16% and 24% of total revenues in 1999, 2000 and 2001, respectively.

Cost of Revenues and Operating Expenses

Cost of initial license fees. Costs of initial license fees were \$1.4 million, \$1.6 million and \$1.5 million in 1999, 2000 and 2001, respectively, representing 13%, 16% and 18% of initial license fees in 1999, 2000 and 2001, respectively. Cost of initial license fees includes documentation, reproduction costs, product packaging and media, employment costs for installation and distribution personnel, the cost of third party software and amortization of previously capitalized software development costs. The decrease in 2001 compared to 2000 was due to lower sales and a decrease in the amortization of software. The increase in 2000 compared to 1999 was primarily the result of expensing the remainder of the capitalized software costs of VCPro 2.0 due to the 4th quarter 2000 release of VCPro 3.0.

Cost of annual renewal license and support fees. Costs of annual license fees were \$947,000, \$1.3 million and \$1.5 million 1999, 2000 and 2001, respectively, representing 13%, 15% and 17% of annual license fees in 1999, 2000 and 2001, respectively. Costs of annual renewal license fees consist principally of the employment-related costs for our technical support staff. The increase in 2001 compared to 2000 was due to additional technical support personnel necessary to support our increasing customer base. The increase in 2000 compared to 1999 was due to the implementation of a new technical support database and additional technical support personnel necessary to support our increasing customer base.

Cost of services and other. Costs of services and other were \$3.6 million, \$2.5 million and \$3.0 million in 1999, 2000 and 2001, respectively, representing 58%, 68% and 58% of services and other revenue in 1999, 2000

and 2001, respectively. Costs of services and other consist principally of the employment-related costs of our consulting and training staff. The increase in 2001 compared to 2000 was primarily due to additional personnel costs and the greater use of outside consultants to complete our increased consulting work in 2001. The decrease in 2000 compared to 1999 was primarily due to attrition and transferring underutilized personnel to other departments.

Research and development. Research and development expenses were \$4.7 million, \$4.2 million and \$5.2 million in 1999, 2000 and 2001, respectively, representing a decrease of 11% from 1999 to 2000 and an increase of 24% from 2000 to 2001. Research and development expenses consist primarily of the employment-related costs of personnel associated with developing new products, enhancing existing products, testing software products and developing product documentation. As a percentage of total revenue, research and development expenses were 19%, 18% and 24% in 1999, 2000 and 2001, respectively. We anticipate that we will continue to direct significant resources to the development and enhancement of our products. In connection with a development services and referral agreement effective January 16, 2002, we have signed a two-year agreement with Objectiva Software Solutions, Inc. to provide us development services, which could range up to \$3.1 million.

We capitalized software development costs of \$643,000, \$1.2 million and \$717,000 in 1999, 2000 and 2001, respectively. Some of the new products started in 2001 have yet to reach technological feasibility. The amount of software development costs to be capitalized in the future may change if the time between the establishment of technological feasibility of a product and its general release changes.

Selling and marketing. Selling and marketing expenses were \$7.7 million, \$8.4 million and \$7.2 million in 1999, 2000 and 2001, respectively, representing an increase of 9% from 1999 to 2000 and a decrease of 14% from 2000 to 2001. Selling and marketing expenses consist primarily of salaries, commissions, marketing programs and related costs for pre- and post-sales activity. The decrease in 2001 was primarily due to fewer personnel and decreased commissions due to decreased initial license fees. The increase in 2000 was primarily due to increased marketing expenditures on advertising, promotion activities and trade shows. Selling and marketing expenses were 32%, 37% and 32% of total revenues in 1999, 2000 and 2001, respectively.

General and administrative. General and administrative expenses were \$4.6 million, \$5.0 million and \$3.4 million in 1999, 2000 and 2001, respectively, representing an increase of 9% from 1999 to 2000 and a decrease of 32% from 2000 to 2001. General and administrative expenses consist of employment-related costs for finance, administration and human resources, allowance for doubtful accounts and general corporate management expenses, including legal and audit fees. The decrease in 2001 was primarily due to decreased personnel and outside consultant costs. The increase in 2000 was primarily due to an increase in the allowance for doubtful accounts and higher professional fees. General and administrative expenses were 19%, 22% and 15% of total revenues in 1999, 2000 and 2001, respectively.

Other income (expense). Other income (expense) is composed of interest income from cash and cash equivalents and short-term investments offset by interest expense related to notes to Xerox and losses on disposal of fixed assets. Other income was \$745,000, \$961,000 and \$281,000 in 1999, 2000 and 2001, respectively. The decrease in 2001 was the result of less interest income following a large decrease in our cash balances as a result of our tender offer which was completed in April 2001. The increase in 2000 was from higher cash balances which generated higher interest income.

Provision for income taxes. The provision for income taxes in 2000 and 2001 was for taxes under the alternative minimum tax. Effective tax rates were approximately 0%, 3% and 0% in 1999, 2000 and 2001, respectively. These rates differ from the federal statutory rate primarily due to the change in the valuation allowances offsetting deferred tax assets.

Factors That May Affect Future Operating Results

Our total revenues and operating results can vary, sometimes substantially, from quarter to quarter and are expected to vary significantly in the future. Our revenues and operating results are difficult to forecast. Future results will depend upon many factors, including the demand for our products, the level of product and

price competition, the length of our sales cycle, the size and timing of individual license transactions, the delay or deferral of customer implementations, the budget cycles of our customers, our success in expanding our direct sales force and indirect distribution channels, the timing of new product introductions and product enhancements by us and our competitors, the mix of products and services sold, levels of international sales, activities of and acquisitions by competitors, the timing of new hires, changes in foreign currency exchange rates, our ability to develop and market new products, controlling costs and general domestic and international economic conditions. In addition, our sales generally reflect a relatively high amount of revenue per order, and, therefore, the loss or delay of individual orders could have a significant impact on our revenues and quarterly operating results. In addition, a significant amount of our revenues occur predominantly in the third month of each fiscal quarter and tend to be concentrated in the latter half of that third month.

Our software products generally are shipped as orders are received. As a result, initial license fees in any quarter are substantially dependent on orders booked and shipped in that quarter. The timing of receipt of initial license fees is difficult to predict because of the length of our sales cycle, typically three to twelve months from the initial contact. Because our operating expenses are based on anticipated revenue trends and because a high percentage of our expenses are relatively fixed, a delay in the recognition of revenue from a limited number of initial license transactions could cause significant variations in operating results from quarter to quarter and could result in losses. To the extent such expenses precede, or are not subsequently followed by, increased revenues, our operating results could be materially adversely affected.

Due to the foregoing factors, revenues and operating results for any quarter are subject to significant variation, and we believe that period-to-period comparisons are not necessarily meaningful and should not be relied upon as indications of future performance.

Liquidity and Capital Resources

At December 31, 2001, we had \$8.9 million in cash, cash equivalents and short-term investments. This is a decrease of \$9.6 million from December 31, 2000, which was used primarily to purchase 6,000,000 shares of our common stock at \$2.00 per share pursuant to our tender offer. On April 16, 2001, we executed two promissory notes payable to Xerox to purchase an additional 1,139,600 shares of our common stock owned by Xerox at \$2.00 per share. The principal amount of the first note was \$2,000,000 and accrued interest at 9%. This note was due on March 23, 2002. The principal amount of the second note was \$279,200 and accrued interest at 9%. This note was due on March 23, 2003. Both of these notes were paid in full on February 15, 2002.

We believe that our existing cash balances and anticipated cash flows from operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures at least through the next twelve months. A portion of our remaining cash could be used to acquire or invest in complementary businesses or products or obtain the right to use complementary technologies. We are currently evaluating, in our ordinary course of business, potential investments such as businesses, products or technologies. We have no material current understandings, commitments or agreements with respect to any acquisition in whole of other businesses, products or technologies.

As of December 31, 2000 and 2001, we did not have any other relationships with unconsolidated entities or financial partners, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Recently Issued Accounting Standards

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* and No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for by the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment.

Separate intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective January 1, 2002. Effective January 1, 2002, we will discontinue amortization of goodwill, which will reduce annual operating expenses by approximately \$70,000.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment of long-lived assets and supercedes SFAS No. 121, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations for a Disposal of a Segment of a Business*. We are required to adopt SFAS No. 144 effective January 1, 2002. We do not expect the adoption of SFAS No. 144 will have a significant impact on our operating results and financial condition.

Euro Conversion

In January 1999, a new currency called the "Euro" was introduced in certain Economic and Monetary Union (EMU) countries. Our subsidiary, Document Sciences Europe, is based in one of these countries, France. During 2002, most EMU countries converted to the Euro as their single currency. Although the conversion has gone smoothly, we cannot assure you that there will not be any future material adverse effects on our financial position.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

Foreign Currency Exchange Risk

Our earnings and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. To a certain extent, foreign currency exchange rate movements also affect our competitive position, as exchange rate changes may affect business practices and/or pricing strategies on non-U.S. based competitors. The primary foreign currency risk exposure is related to U.S. Dollar to Euro conversions. Considering both the anticipated cash flows from firm sales commitments and anticipated sales for the next quarter, a hypothetical 10% weakening of the U.S. Dollar relative to all other currencies would not materially adversely affect expected first quarter 2002 earnings or cash flows. This analysis is dependent on actual export sales during the next quarter occurring within 90% of budgeted forecasts. The effect of the hypothetical change in exchange rates ignores the affect this movement may have on other variables including competitive risk. If it were possible to quantify this competitive impact, the results could well be different than the sensitivity effects described above. In addition, it is unlikely that all currencies would uniformly strengthen or weaken relative to the U.S. Dollar. In reality, some currencies may weaken while others may strengthen. Each month we review our position for expected currency exchange rate movements.

Interest Rate Risk

We are exposed to changes in interest rates primarily from our short-term available-for-sale investments. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. A hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest sensitive financial instruments at December 31, 2001. Declines in interest rates over time will, however, reduce our interest income.

Item 8. *Financial Statements and Supplementary Data*

The financial statements and supplementary data required by this item are set forth at the end of this Annual Report on Form 10-K beginning on page F-1 and is incorporated into this item by reference.

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

None.

PART III

Item 10. *Directors and Executive Officers of the Registrant*

The information required by this item concerning our directors and certain information regarding our executive officers is incorporated by reference to the information set forth in the sections entitled "Election of Directors — Nominees," "Compensation of Executive Officers" and "Section 16(a) Beneficial Ownership Reporting Compliance" in our Proxy Statement for the 2002 Annual Meeting of Stockholders.

Executive Officers of Document Sciences

The executive officers of Document Sciences and their ages, as of March 1, 2002, are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
John L. McGannon	41	President, Chief Executive Officer and Chief Financial Officer
Daniel J. Fregeau	45	Executive Vice President
J. Douglas Pike	46	Vice President, Worldwide Sales
Lisa L. Sutrick	38	Vice President, Product Planning and Development

John L. McGannon has served as President and Chief Executive Officer since January 2001 and Chief Financial Officer since December 1999. He has also served as Vice President, Chief Administrative Officer and Controller since joining Document Sciences in September 1998. From June 1997 through August 1998, Mr. McGannon served as the Manager of Financial Analysis and Planning for Simulation Sciences, Inc., a California-based software developer for the oil and chemical engineering industries. Mr. McGannon worked for Chevron Corporation from 1988 to 1997 in a variety of financial management positions. Mr. McGannon holds a BA degree from Stanford University and an MBA from Carnegie Mellon University.

Daniel J. Fregeau has served as Executive Vice President since January 2001. From 1998 to 2001, he served as Vice President of Worldwide Sales and Business Development, from 1997 to 1998, he served as Vice President, Business Development, from 1994 to 1997, he served as Vice President, Marketing and from 1992 to 1994, he served as Vice President, Sales. Prior to joining Document Sciences, Mr. Fregeau was Marketing Manager for the Networking Division of Sears Business Centers, San Diego, from 1990 to 1992. Mr. Fregeau was a founder and principal of MicroAge in San Diego from 1988 to 1990. From 1982 to 1988, Mr. Fregeau held several positions with Xerox Corporation's Electronic Publishing Business Unit including Manager of Systems Engineering and Integration, Technical Program Manager and Project Manager. While at Xerox, Mr. Fregeau designed and directed the development of several publishing products and was a key contributor to the launch of the XICS (now CompuSet) product in the U.S. and Canada.

J. Douglas Pike has served as Vice President, Worldwide Sales since January 2001. He had previously served as Director of US Sales and Area Sales Manager since joining Document Sciences in January 1995. From 1990 to 1994, Mr. Pike was employed by Xerox Corporation to provide digital printing solutions to major accounts in the insurance and finance industries. Mr. Pike also worked for Unisys Corporation for seven years providing custom software application and database solutions as an account executive. Mr. Pike holds a B.S. degree in Industrial Technology from the State University of New York.

Lisa L. Sutrick has served as Vice President, Product Planning and Development since January 2002. She had previously served in the capacities of Director of Product Planning and Development, Director of Product Marketing, Product Marketing Manager for Document Library Services and Program Manager in Development since joining Document Sciences in May 1997. From 1987 to 1997, Ms. Sutrick worked for Data Retrieval Corporation, a Wisconsin software company purchased by Document Sciences in May 1997, in a

variety of customer focused software development positions. Ms. Sutrick holds a B.S. degree in Applied Mathematics from the University of Wisconsin, Stout.

Executive officers are appointed by the Board of Directors and serve at the discretion of the Board. There are no family relationships among any directors or executive officers of Document Sciences.

Item 11. Executive Compensation

The information required by this item regarding executive compensation is incorporated by reference to the information set forth in the sections entitled "Executive Officer Compensation" and "Compensation of Directors" in our Proxy Statement for the 2002 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this item regarding security ownership of certain beneficial owners and management is incorporated by reference to the information set forth in the section entitled "Security Ownership of Management and Certain Beneficial Owners" in our Proxy Statement for the 2002 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions

The information required by this item regarding certain relationships and related transactions is incorporated by reference to the information set forth in the section entitled "Certain Transactions" in our Proxy Statement for the 2002 Annual Meeting of Stockholders.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) The following documents are filed as part of this Form 10-K:

1. *Financial Statements.* The financial statements, related notes thereto and the Report of Independent Auditors required hereunder are set forth at the end of this Annual Report beginning on the page F-1.

2. *Financial Statement Schedule.* The following financial statement schedule for the fiscal years ended December 31, 1999, 2000 and 2001 is filed as part of this Form 10-K and should be read in conjunction with our consolidated financial statements and related notes thereto.

Schedule II Valuation and Qualifying Accounts

Schedules other than those listed above have been omitted since they are either not required, not applicable or the information is otherwise included.

3. *Exhibits.* See Item 14(c) below.

(b) *Reports on Form 8-K.* No reports on Form 8-K were filed by us during the fiscal quarter ended December 31, 2001.

(c) *Exhibits.* The exhibits listed on the accompanying index to exhibits immediately following the financial statement schedules are filed as part of, or incorporated by reference into, this Form 10-K.

(d) *Financial Statement Schedules.* See Item 14(a) above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized on this 1st day of March 2002.

DOCUMENT SCIENCES CORPORATION

By: /s/ JOHN L. MCGANNON
John L. McGannon
President and Chief Executive Officer

Dated: March 1, 2002

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints John L. McGannon his attorney-in-fact, with full power of substitution, for him in any and all capacities, to sign any and all amendments to this Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact or his substitute, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Form 10-K has been signed below by the following persons on behalf of the Registrant on March 1, 2002 in the capacities indicated:

<u>Signatures</u>	<u>Title</u>
<u>/s/ JOHN L. MCGANNON</u> John L. McGannon	President, Chief Executive Officer, Chief Financial Officer and Director (principal executive, financial and accounting officer)
<u>/s/ THOMAS L. RINGER</u> Thomas L. Ringer	Chairman of the Board of Directors
<u>/s/ BARTON L. FABER</u> Barton L. Faber	Director
<u>/s/ COLIN J. O'BRIEN</u> Colin J. O'Brien	Director
<u>/s/ JAMES J. COSTELLO</u> James J. Costello	Director

(This page intentionally left blank)

DOCUMENT SCIENCES CORPORATION
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page</u>
Report of Ernst & Young LLP, Independent Auditors	F-2
Consolidated Balance Sheets	F-3
Consolidated Statements of Income	F-4
Consolidated Statements of Stockholders' Equity	F-5
Consolidated Statements of Cash Flows	F-6
Notes to Consolidated Financial Statements	F-7

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders
Document Sciences Corporation

We have audited the accompanying consolidated balance sheets of Document Sciences Corporation (the "Company") as of December 31, 2000 and 2001, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Document Sciences Corporation at December 31, 2000 and 2001, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP

San Diego, California
January 18, 2002

DOCUMENT SCIENCES CORPORATION
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2000	2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,768,520	\$ 3,187,229
Short-term investments	13,783,595	5,736,200
Accounts receivable, less allowance for doubtful accounts of \$1,012,177 and \$427,683 in 2000 and 2001, respectively	6,084,249	5,028,059
Due from affiliates	1,604,097	1,739,739
Unbilled revenue	269,428	400,164
Other current assets	779,018	519,163
Total current assets	27,288,907	16,610,554
Property and equipment, net	1,930,699	1,178,600
Computer software costs, net of accumulated amortization of \$2,706,041 and \$1,288,326 in 2000 and 2001, respectively	1,364,636	1,143,618
Goodwill, net of accumulated amortization of \$257,121 and \$327,246 in 2000 and 2001, respectively	794,739	724,615
Other assets	117,413	48,785
	<u>\$31,496,394</u>	<u>\$19,706,172</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 332,893	\$ 191,919
Accrued compensation	953,195	881,791
Other accrued liabilities	532,858	520,599
Deferred revenue	8,319,390	7,851,670
Short-term notes	—	2,128,219
Total current liabilities	10,138,336	11,574,198
Long-term notes	—	297,099
Deferred revenue — long-term	224,049	134,430
Commitments		
Stockholders' equity:		
Common stock, \$.001 par value; Authorized shares — 30,000,000;		
Issued shares — 10,923,101 in 2000 and 3,824,896 in 2001	10,923	3,825
Treasury stock — 87,962 and 0 in 2000 and 2001	(503,273)	—
Additional paid-in capital	25,436,306	10,781,055
Accumulated comprehensive income	8,462	95,514
Retained deficit	(3,818,409)	(3,179,949)
Total stockholders' equity	<u>21,134,009</u>	<u>7,700,445</u>
	<u>\$31,496,394</u>	<u>\$19,706,172</u>

See accompanying notes.

DOCUMENT SCIENCES CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	1999	2000	2001
Revenues:			
Initial license fees (including \$3,138,700, \$2,671,800 and \$1,717,700 from affiliates in 1999, 2000 and 2001, respectively)	\$10,405,839	\$10,257,633	\$ 8,200,159
Annual renewal license and support fees (including \$1,604,600, \$2,235,700 and \$2,182,500 from affiliates in 1999, 2000 and 2001, respectively)	7,607,077	8,620,958	8,707,247
Services and other (including \$430,300, \$279,900 and \$224,500 from affiliates in 1999, 2000 and 2001, respectively)	6,292,324	3,700,336	5,212,231
Total revenues	24,305,240	22,578,927	22,119,637
Cost of revenues:			
Initial license fees	1,375,892	1,643,617	1,495,073
Annual renewal license and support fees	947,445	1,311,196	1,498,664
Services and other	3,628,909	2,501,372	2,992,555
Total cost of revenues	5,952,246	5,456,185	5,986,292
Gross profit	18,352,994	17,122,742	16,133,345
Operating expenses:			
Research and development	4,679,067	4,154,364	5,203,525
Selling and marketing	7,680,764	8,358,577	7,151,651
General and administrative	4,626,854	5,025,417	3,418,823
Total operating expenses	16,986,685	17,538,358	15,773,999
Income (loss) from operations	1,366,309	(415,616)	359,346
Interest and other income, net	744,566	960,581	280,921
Income before provision for income taxes	2,110,875	544,965	640,267
Provision for income taxes	—	14,026	1,807
Net income	\$ 2,110,875	\$ 530,939	\$ 638,460
Net income per share — basic	\$ 0.20	\$ 0.05	\$ 0.12
Weighted average shares used in basic calculation	10,693,888	10,771,588	5,547,872
Net income per share — diluted	\$ 0.20	\$ 0.05	\$ 0.11
Weighted average shares used in diluted calculation	10,816,948	11,153,893	5,830,728

See accompanying notes.

DOCUMENT SCIENCES CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Treasury Stock		Additional Paid-in Capital	Deferred Compensation	Accumulated Comprehensive Income (Loss)	Retained (Deficit)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount					
Balance at December 31, 1998 ..	10,857,958	\$10,858	223,158	\$ (686,989)	\$ 25,409,399	\$(67,326)	\$ 204,071	\$(6,460,223)	\$ 18,409,790
Issuance of common stock upon exercise of options	61,093	61	—	—	16,410	—	—	—	16,471
Sale of treasury stock	—	—	(48,276)	77,006	—	—	—	—	77,006
Amortization of deferred compensation	—	—	—	—	—	56,532	—	—	56,532
Comprehensive income (loss):									
Net change in unrealized loss on short-term investments ..	—	—	—	—	—	—	(271,098)	—	(271,098)
Foreign currency translation adjustment	—	—	—	—	—	—	(119,473)	—	(119,473)
Net loss	—	—	—	—	—	—	—	2,110,875	2,110,875
Comprehensive income									1,720,304
Balance at December 31, 1999 ..	10,919,051	10,919	174,882	(609,983)	25,425,809	(10,794)	(186,500)	(4,349,348)	20,280,103
Issuance of common stock upon exercise of options	4,050	4	—	—	10,497	—	—	—	10,501
Sale of treasury stock	—	—	(86,920)	106,710	—	—	—	—	106,710
Amortization of deferred compensation	—	—	—	—	—	10,794	—	—	10,794
Comprehensive income (loss):									
Net change in unrealized gain on short-term investments ..	—	—	—	—	—	—	212,916	—	212,916
Foreign currency translation adjustment	—	—	—	—	—	—	(17,954)	—	(17,954)
Net income	—	—	—	—	—	—	—	530,939	530,939
Comprehensive income									725,901
Balance at December 31, 2000 ..	10,923,101	10,923	87,962	(503,273)	25,436,306	—	8,462	(3,818,409)	21,134,009
Issuance of common stock upon exercise of options	44,406	44	—	—	11,939	—	—	—	11,983
Warrants issued to non-employee	—	—	—	—	30,600	—	—	—	30,600
Purchase of treasury stock	—	—	7,144,854	(14,294,972)	—	—	—	—	(14,294,972)
Sale of treasury stock	—	—	(90,204)	93,313	—	—	—	—	93,313
Retirement of treasury stock	(7,142,611)	(7,142)	(7,142,612)	14,704,932	(14,697,790)	—	—	—	—
Comprehensive income (loss):									
Net change in unrealized gain on short-term investments ..	—	—	—	—	—	—	82,686	—	82,686
Foreign currency translation adjustment	—	—	—	—	—	—	4,366	—	4,366
Net income	—	—	—	—	—	—	—	638,460	638,460
Comprehensive income									725,512
Balance at December 31, 2001 ..	<u>3,824,896</u>	<u>\$ 3,825</u>	<u>—</u>	<u>\$ —</u>	<u>\$ 10,781,055</u>	<u>\$ —</u>	<u>\$ 95,514</u>	<u>\$(3,179,949)</u>	<u>\$ 7,700,445</u>

See accompanying notes.

DOCUMENT SCIENCES CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	1999	2000	2001
Operating activities			
Net income	\$ 2,110,875	\$ 530,939	\$ 638,460
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	529,188	652,837	700,666
Amortization of goodwill	70,124	70,124	70,124
Loss on disposal of fixed assets	25,881	36,534	176,378
Amortization of computer software costs	694,362	1,158,170	937,774
Amortization of deferred compensation	56,532	10,794	—
Provision for doubtful accounts	44,510	245,170	(584,312)
Changes in operating assets and liabilities, net of effects of acquired business:			
Accounts receivable	(1,885,316)	(264,438)	1,640,037
Due from affiliates	(283,754)	280,251	(139,683)
Unbilled revenue	83,538	38,635	(130,736)
Income tax receivable	331,337	—	—
Other assets	(395,671)	17,411	328,341
Accounts payable	(456,309)	(272,146)	(140,974)
Accrued compensation	7,935	(923,771)	(71,255)
Accrued liabilities	(1,075,860)	(163,976)	134,622
Deferred revenue	(844,986)	1,589,169	(556,618)
Net cash provided by (used in) operating activities	(987,614)	3,005,703	3,002,824
Investing activities			
Purchases of short-term investments	(16,298,225)	(7,280,780)	(4,705,851)
Sales of short-term investments	12,784,046	340,284	11,014,139
Maturities of short-term investments	2,935,000	6,900,000	1,850,000
Purchases of property and equipment, net	(709,568)	(905,449)	(132,963)
Proceeds from disposal of assets	29,640	73,044	7,747
Additions to computer software costs	(642,820)	(1,190,758)	(716,756)
Net cash provided by (used in) investing activities	(1,901,927)	(2,063,659)	7,316,316
Financing activities			
Principal payments under capital lease obligations	(41,566)	(12,620)	—
Purchase of treasury stock	—	—	(12,015,772)
Sale of treasury stock	77,006	106,710	93,313
Proceeds from issuance of common stock	16,471	10,501	42,583
Net cash provided by (used in) financing activities	51,911	104,591	(11,879,876)
Increase (decrease) in cash and cash equivalents	(2,837,630)	1,046,635	(1,560,736)
Effect of foreign currency on cash	(110,433)	(24,472)	(20,555)
Cash and cash equivalents at beginning of year	6,694,420	3,746,357	4,768,520
Cash and cash equivalents at end of year	<u>\$ 3,746,357</u>	<u>\$ 4,768,520</u>	<u>\$ 3,187,229</u>
Supplemental disclosure of cash flow information:			
Interest paid	<u>\$ 3,108</u>	<u>\$ 1,040</u>	<u>\$ —</u>
Notes issued for purchase of treasury stock	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2,279,200</u>

See accompanying notes.

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Organization

Document Sciences Corporation was incorporated on October 18, 1991 in Delaware as a subsidiary of Xerox Corporation (Xerox). We develop, market and support a family of document automation software products and services used in high volume electronic publishing applications. *Autograph*, our document automation software architecture, enables personalized publishing solutions for many industries including insurance, managed healthcare, financial services, commercial print services, government, telecommunications and manufacturing.

We currently derive substantially all of our license revenues from licenses of CompuSet, *Autograph's* flagship product, and related products and from fees for services related to the CompuSet software. Our financial performance will continue to depend, in significant part, on the successful development, introduction and customer acceptance of new and enhanced versions of the CompuSet software and related products. There can be no assurance that we will continue to be successful in developing and marketing CompuSet products and related services.

We currently have a variety of contractual and informal relationships with Xerox and affiliates of Xerox, including a cooperative marketing agreement, a transfer and license agreement and various distribution agreements. There can be no assurance that Xerox or its affiliates will continue these relationships. Our failure to maintain these relationships with Xerox and its affiliates could have a material adverse effect on our financial statements.

Basis of Presentation

In 1994, we established a wholly owned subsidiary, Document Sciences Europe, in France, in order to market and support our products to the European community. The accompanying consolidated financial statements include the accounts of all our operations. Significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported in the financial statements, as well as the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Foreign Operations

The functional currency of our French subsidiary in 2001 was the French Franc. Beginning January 1, 2002, the functional currency became the Euro. The balance sheet accounts of our subsidiary are translated into U.S. Dollars at exchange rates prevailing at the balance sheet dates. Revenues and expenses are translated into U.S. Dollars at the average rates of exchange during the period. Foreign currency translation gains are recorded as a separate component of stockholders' equity. Foreign currency transaction gains and losses are included in selling and marketing expenses in the consolidated statements of operations and were not significant during the years ended December 31, 1999, 2000 and 2001.

Cash, Cash Equivalents and Short-term Investments

Cash and cash equivalents consist of cash and highly liquid investments that include debt securities with remaining maturities when acquired of three months or less and are stated at fair market value. We evaluate

DOCUMENT SCIENCES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the financial strength of institutions at which significant investments are made and believe the related credit risk is limited to an acceptable level.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, we have classified our investments as available-for-sale. Available-for-sale securities are carried at fair value. Unrealized gains and losses, net of tax, are reported in stockholders' equity. Realized gains and losses and declines in value judged to be other-than-temporary, if any, on available-for-sale securities will be included in investment income. The cost of securities sold is based on the specific identification method.

Concentration of Credit Risk

We sell our products primarily to large, multinational customers in the United States, Europe, Canada, Australia and Brazil. We derived 25%, 28% and 21% of our total revenues from customers outside the United States for the years ended December 31, 1999, 2000 and 2001, respectively. A significant concentration of our customers is in the insurance, finance and commercial print service industries. Xerox was the only customer that accounted for more than 10% of our revenue in any one year. They accounted for 21%, 23% and 19% for the years ended December 31, 1999, 2000 and 2001, respectively.

Credit is extended based on an evaluation of the customer's financial condition and a cash deposit is generally not required. We estimate our potential losses on trade receivables on an ongoing basis and provide for anticipated losses in the period in which the revenues are recognized.

Impairment of Long-Lived Assets

In accordance with SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, we record impairment losses on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the asset's carrying amount. SFAS No. 121 also addresses the accounting for long-lived assets that are expected to be disposed of. To date, no such impairments have been identified.

Computer Software Costs

In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*, costs incurred in the research and development of new software products and significant enhancements to existing software products are expensed as incurred until the technological feasibility of the product has been established. After technological feasibility has been established, direct production costs, including programming and testing, are capitalized until general release of the product.

Capitalized costs of software to be sold, licensed or otherwise marketed are amortized using the greater of the amount computed using the ratio of current period product revenues to estimated total product revenues or the straight-line method over the remaining estimated economic lives of the products. It is possible that estimated total product revenues, the estimated economic life of the product, or both, will be reduced in the future. As a result, the carrying amount of capitalized software costs may be reduced in the future, which could cause our operating results in future periods to be adversely affected.

Depreciation and Amortization

Depreciation is provided on a straight-line method over the estimated useful lives of the assets (generally three to seven years). Amortization of leasehold improvements is provided over the lesser of the remaining lease term or the estimated useful life of the improvements. Prior to 2002, amortization of goodwill was provided over an estimated life of 15 years. Beginning in 2002, we will adopt SFAS No. 142, *Goodwill and Other Intangible Assets*, which states that we annually review goodwill for impairment.

DOCUMENT SCIENCES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Revenue Recognition

We recognize revenue in accordance with SOP 97-2, *Software Revenue Recognition* and SAB No. 101, *Revenue Recognition in Financial Statements*. Initial license fees are recognized when a contract exists, the fee is fixed and determinable, software delivery has occurred and collection of the receivable is deemed probable. The fair value of the initial license fee representing the software support for the first year is deferred and recognized ratably over the period of support. Annual renewal license and support fees are recognized ratably over the contract period. Revenues generated from consulting services are recognized as the related services are performed. However, when such consulting services are deemed to be essential to the functionality of the delivered software product, revenue from the entire arrangement is recognized on a percentage of completion method or not until the contract is completed in accordance with SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, and ARB No. 45, *Long-Term Construction-Type Contracts*.

Computation of Net Income Per Share

In accordance with SFAS No. 128, *Earnings per Share*, "Basic EPS" includes no dilution and is based on weighted-average common shares outstanding for the period. SFAS No. 128 also requires companies with complex capital structures to present "Diluted EPS" that reflects the potential dilution of securities such as employee stock options.

In 1999, 2000 and 2001, the difference between weighted-average shares used in determining Basic EPS versus Diluted EPS related to dilutive common stock options totaled 123,060, 382,305 and 282,856 shares, respectively. Common stock options to purchase 448,908, 227,722 and 282,274 shares were excluded from the calculation of weighted-average shares used in determining Diluted EPS for 1999, 2000 and 2001, respectively, as their effect would have been antidilutive.

Stock Options

As permitted by SFAS No. 123, *Accounting for Stock-based Compensation*, we have elected to follow APB No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its employee stock options. Under APB Opinion No. 25, among other things, when the exercise price of our employee stock options is not less than the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Income Taxes

We follow the liability method of accounting for income taxes, as set forth in SFAS No. 109, *Accounting for Income Taxes*.

Comprehensive Income

In 1998, we adopted SFAS No. 130, *Reporting Comprehensive Income*. SFAS No. 130 requires that all components of comprehensive income, including net income, be reported in the financial statements in the period they are recognized. Comprehensive income is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Net income and other comprehensive income, including foreign currency translation adjustments and unrealized gains and losses on investments, shall be reported, net of their related tax effect, to arrive at comprehensive income. We have disclosed comprehensive income in our financial statements accordingly.

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Segment Information

In 1998, we adopted SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. SFAS No. 131 amends the requirements for public enterprises to report financial and descriptive information about their reportable operating segments. Operating segments, as defined in SFAS No. 131, are components of an enterprise for which separate financial information is available and is evaluated regularly by a company in deciding how to allocate resources and in assessing performance. This financial information is required to be reported on the basis that is used internally for evaluating the segment performance. The chief operating decision maker does not evaluate our operation based on geographic location, and, therefore, we operate in one business segment, the software business. Geographic information, however, has been disclosed in accordance with the provisions of SFAS No. 131.

Recently Issued Accounting Pronouncements

In July 2001, the FASB issued SFAS No. 141, *Business Combinations* and No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for by the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separate intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective January 1, 2002. Effective January 1, 2002, we will discontinue amortization of goodwill, which will reduce annual operating expenses by approximately \$70,000.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment of long-lived assets and supersedes SFAS No. 121, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations for a Disposal of a Segment of a Business*. We are required to adopt SFAS No. 144 effective January 1, 2002. We do not expect the adoption of SFAS No. 144 will have a significant impact on our operating results and financial condition.

2. Financial Statement Information

Investments

We have classified all of our investment securities as available-for-sale. The following table summarizes available-for-sale securities at December 31, 2000 and 2001:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2000				
U.S. treasury securities	\$ 3,827,316	\$ 3,403	\$11,395	\$ 3,819,324
U.S. government agency obligations	4,123,255	6,406	2,890	4,126,771
U.S. corporate securities	5,844,037	31,933	38,470	5,837,500
	<u>\$13,794,608</u>	<u>\$41,742</u>	<u>\$52,755</u>	<u>\$13,783,595</u>
December 31, 2001				
U.S. government agency obligations	<u>\$ 5,664,527</u>	<u>\$73,139</u>	<u>\$ 1,466</u>	<u>\$ 5,736,200</u>

DOCUMENT SCIENCES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The amortized cost and estimated fair value of available-for-sale securities at December 31, 2001, by contractual maturity, are shown below:

	<u>Cost</u>	<u>Estimated Fair Value</u>
Due in one year or less	\$2,254,900	\$2,271,419
Due after one year through ten years	<u>3,409,627</u>	<u>3,464,781</u>
	<u>\$5,664,527</u>	<u>\$5,736,200</u>

Property and Equipment

Property and equipment are stated at cost and consist of the following at December 31:

	<u>2000</u>	<u>2001</u>
Computer equipment	\$ 2,177,786	\$ 1,358,695
Office equipment	328,249	311,889
Office furniture and fixtures	426,830	448,175
Leasehold improvements	<u>567,649</u>	<u>523,423</u>
	3,500,514	2,642,182
Less accumulated depreciation and amortization	<u>(1,569,815)</u>	<u>(1,463,582)</u>
	<u>\$ 1,930,699</u>	<u>\$ 1,178,600</u>

The cost of equipment acquired under capital leases totaled \$203,853 and \$176,715 at December 31, 2000 and 2001, respectively, with accumulated depreciation of \$188,879 and \$173,773 at December 31, 2000 and 2001, respectively.

3. Segment Information

The tables below summarize our operating results by our major geographic locations in the United States and Europe:

	<u>United States</u>	<u>Europe</u>	<u>Eliminations</u>	<u>Totals</u>
Year ended December 31, 1999				
Sales to unaffiliated customers	\$17,641,284	\$1,490,348	\$ —	\$19,131,632
Sales to affiliates	<u>2,972,985</u>	<u>2,200,623</u>	<u>—</u>	<u>5,173,608</u>
Revenues	<u>\$20,614,269</u>	<u>\$3,690,971</u>	<u>\$ —</u>	<u>\$24,305,240</u>
Operating income (loss)	<u>\$ 1,549,879</u>	<u>\$ (183,570)</u>	<u>\$ —</u>	<u>\$ 1,366,309</u>
Identifiable assets	<u>\$30,106,425</u>	<u>\$ 332,919</u>	<u>\$(16,666)</u>	<u>\$30,422,678</u>

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	<u>United States</u>	<u>Europe</u>	<u>Eliminations</u>	<u>Totals</u>
Year ended December 31, 2000				
Sales to unaffiliated customers	\$15,859,272	\$1,532,215	\$ —	\$17,391,487
Sales to affiliates	<u>2,859,786</u>	<u>2,327,654</u>	<u>—</u>	<u>5,187,440</u>
Revenues	<u>\$18,719,058</u>	<u>\$3,859,869</u>	<u>\$ —</u>	<u>\$22,578,927</u>
Operating income (loss)	<u>\$ (551,081)</u>	<u>\$ 135,465</u>	<u>\$ —</u>	<u>\$ (415,616)</u>
Identifiable assets	<u>\$31,264,827</u>	<u>\$ 248,233</u>	<u>\$ (16,666)</u>	<u>\$31,496,394</u>
	<u>United States</u>	<u>Europe</u>	<u>Eliminations</u>	<u>Totals</u>
Year ended December 31, 2001				
Sales to unaffiliated customers	\$16,949,144	\$1,045,804	\$ —	\$17,994,948
Sales to affiliates	<u>2,495,863</u>	<u>1,628,826</u>	<u>—</u>	<u>4,124,689</u>
Revenues	<u>\$19,445,007</u>	<u>\$2,674,630</u>	<u>\$ —</u>	<u>\$22,119,637</u>
Operating income (loss)	<u>\$ 320,977</u>	<u>\$ 38,369</u>	<u>\$ —</u>	<u>\$ 359,346</u>
Identifiable assets	<u>\$19,530,350</u>	<u>\$ 192,488</u>	<u>\$ (16,666)</u>	<u>\$19,706,172</u>

Sales attributable to the United States were made to customers located in North America, South America and Australia. Sales attributable to Europe are based on those sales generated by our French subsidiary. These sales were made to customers located in Europe, the Middle East and Africa.

4. Leases

We lease our headquarters in Carlsbad, California under an operating lease expiring on February 28, 2005. Under the terms of the lease, effective March 1, 1999, monthly rental payments will be increased annually by 4%. The lease provides us with an option to extend the lease term for an additional five years at the base rent in effect for the last year of the initial lease term plus 4%. Our offices in France and Milwaukee, Wisconsin are under operating leases expiring on April 15, 2004 and March 31, 2003, respectively. Annual future minimum lease payments as of December 31, 2001 are as follows:

<u>Years ending December 31,</u>	
2002	\$ 428,221
2003	298,006
2004	268,815
2005	<u>45,092</u>
	<u>\$1,040,134</u>

Rent expense for the years ended December 31, 1999, 2000 and 2001 was \$451,871, \$492,886 and \$545,202, respectively.

5. Stockholders' Equity

Stock

As of December 31, 2001, authorized capital stock consisted of 30,000,000 shares of common stock and 2,000,000 shares of preferred stock.

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Stock Incentive Plans

Our stock incentive plans provide for the issuance of incentive and nonstatutory options to purchase common shares to eligible employees, officers, directors and consultants. Our 1993 Stock Option Plan (the "1993 Plan") provided for the issuance of up to 1,500,000 shares. In October 1995, the Board of Directors approved the 1995 Stock Incentive Plan (the "1995 Plan"), which provided for the issuance of an additional 779,250 shares which included 29,250 shares previously reserved for issuance under the 1993 Plan. In 1998, 1999 and 2000, this plan was amended to provide for the issuance of an additional 750,000, 350,000 and 1,000,000 shares, respectively. The 1995 Plan replaced the 1993 Plan. All outstanding options under the 1993 Plan remain exercisable in accordance with their original terms. Terms of stock purchase or stock option agreements, including vesting requirements, are determined by the Board of Directors, subject to the provisions of the 1995 Plan. The maximum term of the options granted under the 1995 Plan is ten years. The exercise price of incentive stock options must equal at least the fair market value on the date of grant. The exercise price of nonstatutory stock options and stock issued under purchase rights must equal at least 85% of the fair market value on the date of grant or time of issuance.

The following table summarizes stock option activity under the stock incentive plans:

	Number of Shares	Option Price Per Share	Weighted Average Exercise Price Per Share
Balance at December 31, 1999	1,646,679	\$.03-\$10.00	\$2.10
Granted	161,500	\$1.13-\$ 5.00	\$2.65
Exercised	(4,050)	\$.67	\$.67
Canceled	<u>(169,215)</u>	\$.67-\$10.00	\$2.05
Balance at December 31, 2000	1,634,914	\$.03-\$10.00	\$2.17
Granted	520,150	\$.91-\$ 2.64	\$1.50
Exercised	(44,406)	\$.03-\$ 1.97	\$.27
Canceled	<u>(395,943)</u>	\$1.13-\$10.00	\$2.27
Balance at December 31, 2001	<u>1,714,715</u>	\$.17-\$10.00	\$1.98

As of December 31, 2001, 1,025,964 shares were available for future grant. Following is a breakdown of the options outstanding and exercisable as of December 31, 2001:

Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Life in Years	Weighted Average Exercise Price of Options Outstanding	Options Exercisable	Weighted Average Exercise Price of Options Exercisable
\$.17-\$1.75	796,383	8.37	\$1.39	286,078	\$1.28
\$1.97	536,597	7.70	\$1.97	304,092	\$1.97
\$2.00-\$10.00	<u>381,735</u>	7.09	\$3.18	<u>296,969</u>	\$3.33
Total or Average	<u>1,714,715</u>	7.87	\$1.98	<u>887,139</u>	\$2.20

Adjusted pro forma information regarding our operating results is required by SFAS No. 123, and has been determined as if we had accounted for our employee stock options under the fair value method of that Statement. The fair value of options was estimated at the date of grant using the "Black-Scholes" method for option pricing with the following weighted-average assumptions: risk-free interest rates of 5.5%-6%, dividend yields of 0%, expected volatility of .69 to 1.43 and a weighted-average expected life of the option of seven years.

DOCUMENT SCIENCES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

For purposes of adjusted pro forma disclosures, the estimated fair value of the options is amortized to expense over the option's vesting period. The effect of applying SFAS No. 123 for purposes of providing pro forma disclosures is not likely to be representative of the effects on our operating results for future years because changes in the subjective input assumptions can materially affect future value estimates. Our pro forma information is as follows:

	Years Ended December 31,		
	1999	2000	2001
Adjusted pro forma basic net income (loss)	\$1,466,003	\$(292,321)	\$541,356
Adjusted pro forma basic net income (loss) per share	\$ 0.14	\$ (0.03)	\$ 0.10
Adjusted pro forma diluted net income (loss) per share ..	\$ 0.14	\$ (0.03)	\$ 0.09

Our 1997 Employee Stock Purchase Plan provides for the issuance of shares of our common stock, up to a total of 350,000 shares, to eligible employees. The price of the common shares purchased under the Plan is equal to 85% of the fair market value of the common shares on the first or last day of the offering period, whichever is lower. Employees who choose to participate in the plan can withhold between one and ten percent of their wages. However, an employee cannot purchase more than 5,000 shares in any one offering period. As of December 31, 2001, 59,791 shares were available for issuance.

6. Income Taxes

For financial reporting purposes, income (loss) before income taxes includes the following components:

	Years Ended December 31,		
	1999	2000	2001
United States	\$2,294,445	\$409,500	\$601,898
Foreign	(183,570)	135,465	38,369
	<u>\$2,110,875</u>	<u>\$544,965</u>	<u>\$640,267</u>

The provision for income taxes (benefit) is as follows:

	Years Ended December 31,		
	1999	2000	2001
Current:			
Federal	<u>\$ —</u>	<u>\$14,026</u>	<u>\$1,807</u>

DOCUMENT SCIENCES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deferred income taxes reflect the net effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the deferred tax assets and liabilities are as follows:

	December 31,		
	1999	2000	2001
Deferred tax liabilities:			
Computer software costs expensed for tax	\$ (490,200)	\$ (502,200)	\$ (421,200)
Excess tax depreciation	(149,600)	(138,800)	(80,800)
Total deferred tax liabilities	(639,800)	(641,000)	(502,000)
Deferred tax assets:			
Operating loss carryforwards	2,362,700	1,921,300	1,853,600
Accrued liabilities	413,000	552,300	355,200
Tax credits	231,900	431,600	490,800
Total deferred tax assets	3,007,600	2,905,200	2,699,600
Valuation allowance	2,367,800	2,264,200	2,197,600
Net deferred tax assets	639,800	641,000	502,000
Net deferred tax asset (liability)	\$ 0	\$ 0	\$ 0

A valuation allowance has been recognized to offset deferred tax assets as of December 31, 1999, 2000 and 2001 as realization of such assets is uncertain.

At December 31, 2001, we have federal net operating loss carryforwards of approximately \$5.4 million that will begin expiring in 2018 unless previously utilized. At December 31, 2001, we have federal and state research and development tax credit carryforwards of approximately \$419,000 and \$71,800, respectively, that will begin expiring in 2012 unless previously utilized.

Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of our net operating loss carryforwards may be limited in the event of a cumulative change in ownership of more than 50% within a three-year period.

The differences between our income tax provision and the amounts computed by applying the statutory Federal income tax rate of 35% in 1999, 2000 and 2001 to income before income taxes are as follows:

	December 31,		
	1999	2000	2001
Provision at statutory rate	\$ 738,806	\$ 185,829	\$ 224,093
Benefit for graduated rates	(21,109)	(5,309)	(6,402)
Increase (decrease) in valuation allowance	(820,300)	(103,600)	(66,600)
Permanent differences and other	(102,603)	(62,894)	(149,284)
Provision for income taxes	\$ —	\$ 14,026	\$ 1,807

7. Transactions with Affiliates

We have distribution agreements with affiliates providing the non-exclusive right to sub-license our software in Canada, Australia and Brazil. The terms of the distributor agreements provide that the affiliates receive a discount from the list price of our licensed products and annual license fees. Revenues from the affiliates under these agreements, net of discounts, were \$2.4 million, \$2.4 million and \$2.1 million in 1999,

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2000 and 2001, respectively. Included in accounts receivable are \$900,500, \$707,000 and \$762,600 from these revenues at December 31, 1999, 2000 and 2001, respectively.

We have distribution agreements with affiliates providing the non-exclusive right to sub-license our software in Europe. Revenues under these agreements were \$2.2 million, \$2.3 million and \$1.6 million in 1999, 2000 and 2001, respectively. Related accounts receivable are \$663,300, \$564,500 and \$660,400 at December 31, 1999, 2000 and 2001, respectively.

We also license software to Xerox and affiliates of Xerox in the United States. These revenues were \$263,600, \$443,700 and \$430,300 in 1999, 2000 and 2001, respectively. Related accounts receivable are \$221,400, \$332,600 and \$316,800 at December 31, 1999, 2000 and 2001, respectively.

On February 16, 2001, we commenced a self tender offer for 6,000,000 shares of our outstanding common stock. Xerox tendered all of its shares of Document Sciences common stock in the offer. The tender offer expired on March 23, 2001. In April 2001, we completed our tender offer and purchased 6,000,000 shares of our outstanding common stock for \$2.00 per share.

On February 16, 2001, Xerox also granted us an option to purchase up to 2,000,000 additional shares of our stock it owned after completion of the tender offer at the tender offer price. On April 16, 2001, we executed two promissory notes payable to Xerox pursuant to our exercise of the option to purchase 1,139,600 shares of our common stock owned by Xerox at \$2.00 per share. The principal amount of the first note is \$2,000,000 and accrues interest at 9%. This note is due on March 23, 2002. The principal amount of the second note is \$279,200 and accrues interest at 9%. This note is due on March 23, 2003.

As a result of our tender offer and our exercise of the option to purchase additional shares of Xerox, Xerox presently owns 19.9% of our outstanding shares.

8. Sales Commitments

Since 1999, we have been licensing software for non-cancelable three-year terms. Where we provide extended payment terms to customers (allowing them to make payments on a quarterly or annual basis), we recognize license revenue when invoices come due, as SOP 97-2 precludes us from recognizing the portion of these licenses that is not currently due from the customer. Amounts not currently due from customers on these agreements are not reflected on our Balance Sheet and are identified below.

We also began signing customers to non-cancelable three-year maintenance agreements, which we recognize ratably over the service period. As we invoice these agreements, the amounts are recorded initially as deferred revenue. Amounts to be invoiced are not reflected on our Balance Sheet and are identified below.

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes these multi-year license and maintenance agreement activities showing ending balances not reflected on our Balance Sheet at December 31, 2001:

	Unrecognized Revenue Backlog Maintenance		
	Licenses	Agreements	Totals
Balances at December 31, 1998	\$ -0-	\$ -0-	\$ -0-
1999 additions	1,083,008	3,876,105	4,959,113
Invoiced and included in deferred revenue	(241,978)	(950,588)	(1,192,566)
Balances at December 31, 1999	841,030	2,925,517	3,766,547
2000 additions	66,329	3,171,475	3,237,804
Invoiced and included in deferred revenue	(419,295)	(2,674,323)	(3,093,618)
Balances at December 31, 2000	488,064	3,422,669	3,910,733
2001 additions	23,334	2,830,831	2,854,165
Invoiced and included in deferred revenue	(484,257)	(3,193,020)	(3,677,277)
Balances at December 31, 2001	<u>\$ 27,141</u>	<u>\$ 3,060,480</u>	<u>\$ 3,087,621</u>

All revenue from the unrecognized revenue backlog will have been recognized by the end of the third quarter of 2005.

9. Employee Retirement Plan

401(k) Plan

We have an employee savings and retirement plan (the "401(k) Plan") that is intended to be tax-qualified covering substantially all employees. Under the terms of the 401(k) Plan, employees may elect to contribute up to 15% of their compensation, or the statutory prescribed limit, if less, to the 401(k) Plan as a savings contribution. We may, in our discretion, match employee contributions, at such rate as we determine, up to a maximum of \$3,000 or 10% of the employee's compensation. The 401(k) Plan has a profit sharing element whereby we can contribute annually an amount determined by the Board of Directors. An employee's interest in matching contributions and profit sharing contributions generally vest over four years from the date of employment. For the years ended December 31, 1999, 2000 and 2001, we made discretionary contributions of \$346,200, \$349,500 and \$202,900, respectively.

DOCUMENT SCIENCES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

10. Financial Statements and Supplementary Data

Supplementary interim financial information is presented as follows (unaudited):

	Quarters Ended			
	March 31,	June 30,	September 30,	December 31,
2000				
Revenues.....	\$5,669,926	\$5,215,972	\$4,981,821	\$6,711,208
Cost of revenues.....	1,309,457	1,200,741	1,284,185	1,661,802
Net income.....	413,912	(382,875)	(208,652)	708,554
Basic income per share.....	.04	(.04)	(.02)	.07
Diluted income per share.....	.04	(.04)	(.02)	.07
2001				
Revenues.....	\$5,257,439	\$5,654,141	\$5,032,409	\$6,175,648
Cost of revenues.....	1,683,494	1,394,637	1,337,854	1,570,307
Net income (loss).....	(351,582)	723,488	196,118	70,436
Basic income (loss) per share.....	(.03)	.19	.05	.02
Diluted income (loss) per share.....	(.03)	.19	.05	.02

11. Subsequent Events

Effective January 16, 2002, we entered into a formal two-year development services and referral agreement with Objectiva Software Solutions, Inc. (Objectiva). Document Sciences has engaged Objectiva for development services since January 2001 and has committed to pay Objectiva \$3.1 million over the two-year term of the agreement for development services to be provided by a dedicated team. The agreement is cancelable within 30 days due to material breach or with 90 days notice if all scheduled work has been completed. We would prorate the two-year fee in the case of early termination. Objectiva provided \$750,000 worth of development services to us during the second half of 2001. Additionally, the parties have entered into a referral arrangement under which Objectiva would pay us 20% of net revenue associated with a transaction with a customer that was referred by us.

We are also negotiating agreements whereby we would make an equity investment to acquire approximately 25% of Objectiva's outstanding stock for approximately \$550,000 in cash consideration and would enable Objectiva to resell our software in Asia. It is expected that these agreements would be finalized by the end of the first quarter 2002.

SCHEDULE II

DOCUMENT SCIENCES CORPORATION
VALUATION AND QUALIFYING ACCOUNTS

	<u>Balance at Beginning of Year</u>	<u>Charged to Costs and Expenses</u>	<u>Deductions</u>	<u>Balance at End of Year</u>
Year Ended December 31, 1999				
Allowance for doubtful accounts and returns	\$ 725,561	\$219,482	\$179,170	\$ 765,873
Year Ended December 31, 2000				
Allowance for doubtful accounts and returns	765,873	658,165	411,861	1,012,177
Year Ended December 31, 2001				
Allowance for doubtful accounts and returns	1,012,177	113,000	697,494	427,683

(This page intentionally left blank)

DOCUMENT SCIENCES CORPORATION

ANNUAL REPORT ON FORM 10-K

For Year Ended December 31, 2001

INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Exhibit Description</u>
3.1(1)	Restated Certificate of Incorporation of the Registrant filed May 1, 1992.
3.2(1)	Form of Amended and Restated Certificate of Incorporation of the Registrant.
3.3(1)	Amended and Restated Bylaws of the Registrant.
3.4(1)	Form of Certificate of Amendment of Certificate of Incorporation of the Registrant.
4.1(1)	Specimen Stock Certificate.
4.2(6)	Rights Agreement Between the Registrant and U.S. Stock Transfer Corporation, as Rights Agent, dated May 11, 2001, which includes as Exhibit A thereto the form of Rights Certificate to be Distributed to Holders of Rights after the Distribution Date (as that term is defined in the Rights Agreement).
10.1(1, 2)	Form of Indemnity Agreement Between the Registrant and each of its Officers and Directors.
10.2(1, 2)	1993 Stock Option Plan and Form of Agreement.
10.3(4)	1995 Stock Incentive Plan and Form of Agreement, as amended.
10.4(1, 2)	Stockholder Rights Agreement Dated September 1996 Between the Registrant and Xerox Corporation.
10.5(1)	Tax Sharing Agreement Dated August 1996 Between the Registrant and Xerox Corporation.
10.6(1)	Transfer and License Agreement Dated July 1, 1992, as Amended in September 1994, Between the Registrant and Xerox Corporation.
10.7(1)	Strategic Marketing Alliance Agreement Dated September 1, 1993, Between the Registrant and Xerox Corporation.
10.8(4)	1997 Employee Stock Purchase Plan, as amended.
10.9(3)	Xerox Cooperative Marketing Agreement.
10.10(3)	Xerox Canada Cooperative Marketing and Customer Support Agreement.
10.11(4)	International Business Machines Marketing Agreement.
10.12(4)	Lease for Company's new Principal Facilities, as Amended, and Assignment of Lease.
10.13(2, 5)	John L. McGannon Employment Agreement.
10.14(6)	Form of Software License and Software Support Agreement.
10.15(6)	Form of Professional Services Agreement.
10.16(6)	Form of Value Added Reseller Agreement.
10.17(6)	Development Services and Referral Agreement Between Objectiva Software Solutions, Inc. and the Registrant.
21.1(1)	List of Subsidiaries.
23.1(6)	Consent of Ernst & Young LLP, Independent Auditors.
24.1(6)	Power of Attorney (See page 21)

(1) Previously filed as exhibits to Registration Statement on Form S-1 Registration Number 333-06344.

(2) Indicates management compensatory plan, contract or arrangement.

(3) Previously filed as exhibits to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1997.

(4) Previously filed as exhibits to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1998.

- (5) Previously filed as exhibits to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000
- (6) Filed herewith.

Corporate Offices

Corporate Headquarters
Document Sciences Corporation
6339 Paseo del Lago
Carlsbad, California 92009
760.602.1400

Document Sciences Corporation Europe
115, Rue Réaumur
75002 Paris France
33 (0)1 40 13 77 88

Web site: www.docscience.com

Board of Directors

John L. McGannon
President, Chief Executive Officer and Chief Financial Officer

Thomas L. Ringer
Chairman

Barton L. Faber
Chairman and CEO, FABERcapital

Colin J. O'Brien
Director

James J. Costello
Director, Xerox Corporation
Chief Financial Officer, Xerox Technology Enterprises

Executive Officers

John L. McGannon
President, Chief Executive Officer and Chief Financial Officer

Daniel J. Fregeau
Executive Vice President

J. Douglas Pike
Vice President, Sales

Lisa L. Sutrick
Vice President, Product Planning and Development

Legal Counsel

Gibson, Dunn and Crutcher LLP
Irvine, California

Independent Auditors

Ernst & Young LLP
San Diego, California

Common Stock

Traded on the Nasdaq National Market under the symbol DOCX

Transfer Agent and Registrar

U.S. Stock Transfer Corporation

Direct inquiries to:
1745 Gardena Avenue, Suite 200
Glendale, California 91204-2991

Investor Relations

Heidi Flannery
Fi.Comm
8534 NW Timber Ridge Court
Portland, Oregon 97229-8005

Annual Meeting

The Annual Meeting of Document Sciences Corporation will be held at 9:00 a.m. on Tuesday, April 23, 2002 at:

Grand Pacific Palisades Hotel
5805 Armada Drive
Carlsbad, California 92009
760.827.3200

All stockholders are cordially invited to attend.

Form 10-K

Stockholders (including beneficial holders) may obtain, without charge, a copy of Document Sciences' 2001 Annual Report to the Securities and Exchange Commission on Form 10-K (excluding exhibits) on request to the Corporate Communications Department at the corporate address or through e-mail at jmcgannon@docscience.com.

Forward-Looking Statements

This report contains a number of forward-looking statements, including those regarding continued penetration into existing markets, and sales of products under development and scheduled to be launched during 2002. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, including those described under the "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" sections of the Form 10-K provided with this report.

DOCUMENT SCIENCES
Keep it Personal™

Document Sciences Corporation:
6339 Paseo del Lago
Carlsbad, California 92009

Tel. 760.602.1400
FAX 760.602.1450

www.docscience.com